

# Principles of Credit



# PRINCIPLES OF CREDIT

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In the Financial services industry, credit is a tool used by advisors and lenders to help consumer and business clients achieve their financial goals. In Principles of Credit, students will advise clients about consumer and business lending from the perspective of a lender/finance manager. Students will prepare credit proposals and present credit solutions for both consumers and businesses. Students will also learn how to communicate lending decisions with clients to ensure that financial loss and risk are mitigated.

# PRINCIPLES OF CREDIT

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# 1.

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## Learning Objectives

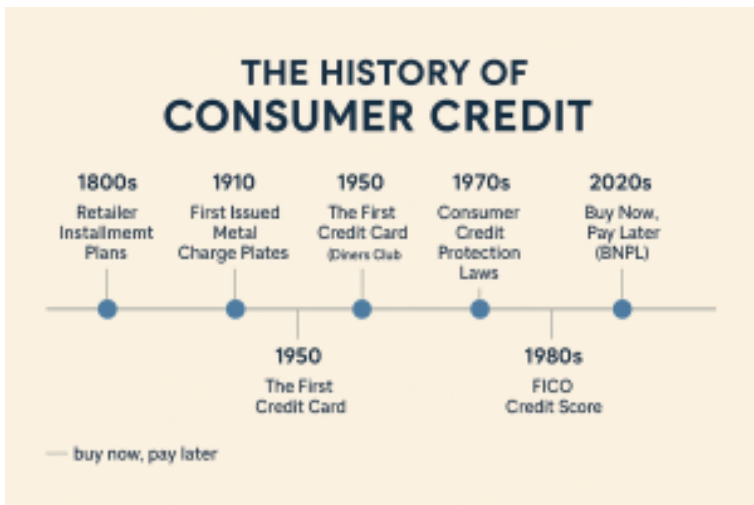
### LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- the history of consumer credit, how it started, and how it has evolved over time.
- the different elements of consumer credit, including the different types of interest rates.
- the different sources of credit and where borrowers go to access credit in Canada.
- to gain insight into global types of credit from the client's perspective by exploring diverse financial systems and practices beyond what is available in Canada.
- the reasons people need credit.

- the role of the lender.

## History of Consumer Credit



The practice of lending has been documented in history for thousands of years. In the beginning, it was rudimentary. Farmers used their seeds, grains, and livestock as repayment, which allowed them to borrow the funds they needed. Lending made it possible to transfer wealth from those with funds to those in need of funds. Lending fuelled and supported communities, which furthered growth and prosperity. From the simple to the complex (where we are

today), the act of lending can still spur growth and wealth creation.

Jeff Desjardins states in his article [\*\*The History of Consumer Credit in One Giant Infographic\*\*](#) that consumer credit has existed for more than 5,000 years. Consumer credit can be dated to 3,500 BC, and it is thought that consumer loans were first used in Sumer (Desjardins, 2017).

Explore Desjardins' article above to review in the link provided to review the history of lending practices! See where they began and how they have continued and evolved into what we see today.

Since these early beginnings, consumers have developed new attitudes and expectations surrounding credit. Consumers now see credit as both a necessity and a means to an end. Credit provides many benefits to consumers, benefits they would not enjoy without credit. Carrying a credit card around is much safer than carrying cash. If a credit card is lost, it can be replaced. The same can't be said about cash. Credit allows consumers to make an immediate purchase rather than delaying the purchase and saving up. It provides that instant satisfaction society desires. In fact, most large items purchased by Canadians are purchased on credit. In 2017, 49% of large-ticket items were purchased on credit (Evans, 2017).

Credit is often used to purchase investments (i.e., shares,

bonds, and real estate), allowing consumers to transfer earnings from their “later years” to the “earlier years” of their adult life. People incur the highest expenses of their lives in their early adult years as they break away from their parents and develop a residence and family of their own. Unfortunately, at this time, their income is usually the lowest it will be throughout their working career. In later years, they usually reach their peak levels of income while their major expenses diminish. The use of credit allows them to utilize future earnings when it is most required and repay it when their income is higher.

### **Interesting Facts about Canada’s History with Credit:**

- **1946:** Creation of the Canadian Mortgage and Housing Corporation (McAfee, 2006).
- **1960s–1970s:** The first credit card was introduced into Canada. It was known as “Chargex” to Canadians (Mussio, 2022).
- **1961:** Vancity Credit Union in British Columbia was the first Canadian financial institution to offer mortgage loans to women without a male co-signer (Nunnikhoven, 2018; Vancity, 2022). Until then, there were women who wanted or needed to buy property on their own, but they couldn’t.

## Commercial Credit



Image generated using the prompt “create an image of Commercial Credit,” sourced from OpenAI, 2025.

*(Commercial credit is briefly introduced here and will be discussed in more depth in subsequent chapters.)*

Commercial credit deals with situations in which capital is needed by a business to meet its cash flow or long-term financing needs. Commercial credit can be less personal and often involves a longer process from the initial meeting to completion. These applications are typically much more in-depth and require additional oversight by the lender.

## Trade Credit

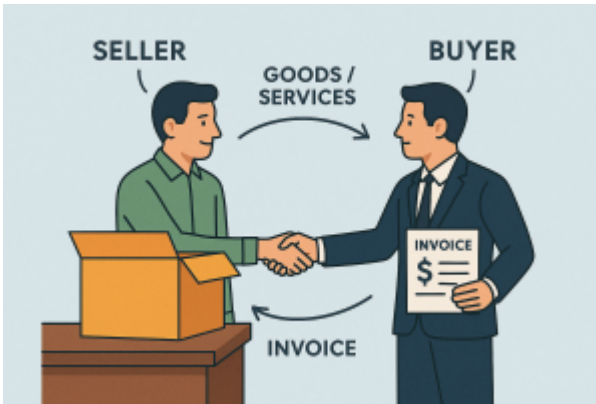


Image generated using the prompt “create an image of Trade Credit,” sourced from OpenAI, 2025.

*(Trade credit is briefly introduced here and will be discussed in more depth in subsequent chapters. )*

Trade credit can be defined as credit granted by one business to another business. Trade credit is all unsecured lending , and the terms of the financing requirements are often very short term. With the unsecured lending element, requests for an extension of credit are scrutinized heavily by the lending business to ensure that repayment will be received.

# Introduction to Consumer Credit



Image generated using the prompt “create an image of Consumer Credit,” sourced from OpenAI, 2025.

## Consumer Lending

Consumer lending can be defined as personal debt taken on to purchase goods and services (Kagan, 2021). It can also provide a cash requirement.

## Understanding Consumer Lending

Consumer debt can be granted by banks and other debt-granting institutions. Receiving the needed funds allows a

client to acquire assets immediately and repay that debt (plus the cost of interest) over time.

## Understanding Interest and Its Place in Lending

Interest is the value applied to any debt that is advanced to a client; it is a monetary charge allowing the client access to these funds. Factors that affect the rate of interest applied to a debt by a lender are the following (Chen, 2022):

- the opportunity cost ;
- the amount of expected inflation;
- the length of time the money is being lent;
- the possibility of government intervention on interest rates; and
- the liquidity of the loan.

## The Types of Interest Rates

There are a variety of interest-rate options that a lender can apply to a loan. Typically, the type of interest rate applied is determined during a conversation a lender has with their client. Knowing the different types of interest rates and how

they are applied can help the lender make the right recommendation to their clients.

### **Fixed rate versus Variable interest.**

A client is buying a car and has agreed to a repayment term of 5 years. The loan officer indicates that the client can receive a fixed interest rate of 6%. This 6% rate will not change over the 5-year term. The loan officer also presents another option in the form of a variable rate interest rate of 5.5%. This rate does seem more attractive, but the rate is tied to the prime rate. In this example, we will say the prime rate is 5.0%. The bank charges an additional 0.5% on top of the prime rate. While the variable rate is lower, the risk to the client is if the prime rate increases, so will their interest rate to reflect the change. The prime rate could decrease, meaning the loan's interest rate will decrease. Ultimately, the client will need to decide on what option they feel most comfortable with.

A **fixed-interest rate** is a rate that is assigned for a term. The rate will be applied for terms of 1, 3, 5, or 7 years. During

the term of the loan/mortgage, the agreed-upon rate does not fluctuate in value. A lender may recommend a fixed rate to their client if they determine the client is risk-averse and would be uncomfortable in an environment of fluctuating interest rates or if the client prefers to know that their payment amount will not change over the course of the term, making it easier for them to budget.

### **PROS**

- Market rate changes will not impact a borrower's monthly payment; they will always know exactly what their payment will be.
- During periods when interest rates are rising, fixed rates do not change.
- For many loans, time frames for can be selected by the borrower; loans can range from 6 months to 10 year non-mortgage loans.

**CONS**

- Under fixed-rate agreement terms, loans are less flexible.
- During periods when interest rates decline, fixed rates do not change.
- Additional fees may be incurred if the borrower seeks to change the terms of the loan or exit the loan early.
- Historically, fixed-rate loans are more expensive over the life of the loan than variable rate loans.

**[Table 1.1] The pros and cons of fixed interest rate loans  
(Source: Lee, 2022)**

A **variable-interest rate** may sometimes be referred to as *adjustable* or *floating*. It is an interest rate that will fluctuate over the term of the loan/mortgage. The reason it fluctuates is because it is based on an underlying benchmark-interest rate or index that can change periodically (Lee, 2022). A lender would recommend a variable-rate interest to their clients when there is a low-interest rate environment.

## **PROS**

- When interest rates fall, loan payments decrease.
- Variable-rate loans usually get superior upfront perks (i.e., lower introductory rates for an initial loan period.)
- A variable-rate loan commonly has a lower-interest rate than a fixed rate loan, primarily when the loan is incurred.

## **CONS**

- When interest rates rise, the loan repayment will increase.
- If interest rates rise rapidly, a variable-rate loan can become more expensive than a fixed-rate loan.
- A borrower can face additional risk if they are already at repayment capacity or are overcapitalized.

- A borrower will have trouble determining what their future cash flow may be due to changing rates.

**[Table 1.2] The pros and cons of variable interest rate loans (Source: Lee, 2022)**

## Is a Fixed or Variable Rate Better?

It comes down to what is better for the client. As demonstrated by the pros and cons of each type of interest rate, it is the responsibility of a lender to guide their client to the type of interest rate that will give them the best outcome from their perspective. If a lender were to offer a variable-interest rate for a client's mortgage and then the client calls when they hear interest rates are rising and ask what they need to do, then clearly a variable-interest rate is not the type of rate best suited for them.

# Lending Sources – Where Can Borrowers Find Sources of Credit?

## Chartered Financial Institutions



Image generated using the prompt “create an image of Chartered Financial Institutions,” sourced from OpenAI, 2025.

Chartered financial institutions make loans to consumer clients and business clients that have met the institution’s requirements for access to credit. Financial institutions have a number of

credit products they would offer to clients, including loans, mortgages, lines of credit, and credit-card accounts. In Canada, there are the “Big Six” chartered banks (Kagan, 2020):

1. National Bank of Canada;
2. Royal Bank;
3. The Bank of Montreal;
4. Canadian Imperial Bank of Commerce;
5. The Bank of Nova Scotia (Scotiabank); and
6. Toronto Dominion Bank (TD).

## Credit Unions



Image generated using the prompt “create an image of Credit Unions” sourced from OpenAI, 2025.

Credit unions are nonprofit organizations/financial cooperatives that are controlled by members who have a common goal, which is providing access to funds that will help members achieve their financial goals. A credit union offers credit in a similar way to a chartered financial institution. However, a credit union may have different qualifying requirements compared to a chartered financial institution that could make it either more challenging or easier for someone to obtain financing. In Alberta, the largest credit union is Servus Credit Union, which dates back to 1938 (Servus Credit Union, 2022).

## Sales Finance Companies



Image generated using the prompt “create an image of Sales Finance Companies,” sourced from OpenAI, 2025.

Sales finance companies offer services to finance big-ticket items, like automobiles, major appliances, furniture, and computer technology. A finance officer works with a client and helps them find financing so they can purchase the item they want/need. For example, a finance officer at a car dealership will take a client’s application and send it to multiple banks/lenders to find the best interest rate available to the client. Often, these rates are better than what a bank can offer.

## Life Insurance Companies



Image generated using the prompt “create an image of Life Insurance Companies,” sourced from OpenAI, 2025.

Canadians who have a permanent insurance policy can borrow against the policy’s cash value for whatever needs they might have. Individuals who borrow from their insurance policy need to be aware that borrowing these funds might lower the amount of money their beneficiaries would receive at the time of the policyholder’s death or the amount the policyholder would receive if they chose to cancel the policy (Financial Consumer Agency of Canada, 2017). It is possible to borrow from a permanent insurance policy, but doing so can impact the amount of funds the beneficiary will receive.

## Pawnbrokers



Image generated using the prompt “create an image of Pawn Brokers,” sourced from OpenAI, 2025.

While pawnbrokers are considered to be an unconventional form of lender, they are, in fact, a common source of secured loans for many Canadians. The pawnbroker holds an individual’s property and lends a portion of the property’s value to the individual. If the individual repays the loan and interest in the agreed-upon amount of time, the individual will receive their property back. Otherwise, the pawnbroker can sell the individual’s property to another customer. Typically, pawnbrokers charge higher rates of interest than other lenders.

## Payday Loans

A payday lender provides short-term loans with high fees to their customers. The setup for the customer is that they can borrow up to \$1500 and then repay the funds from their next

paycheque. In Alberta, customers have up to 62 days to repay the payday lender. These loans come at a high cost to the customer. Payday lenders charge high fees and high-interest rates (equivalent to an interest rate of 500% to 600%), and there may be charges if the customer's pre-authorized debit does not have sufficient funds to cover what is owed (Financial Consumer Agency of Canada, 2020).

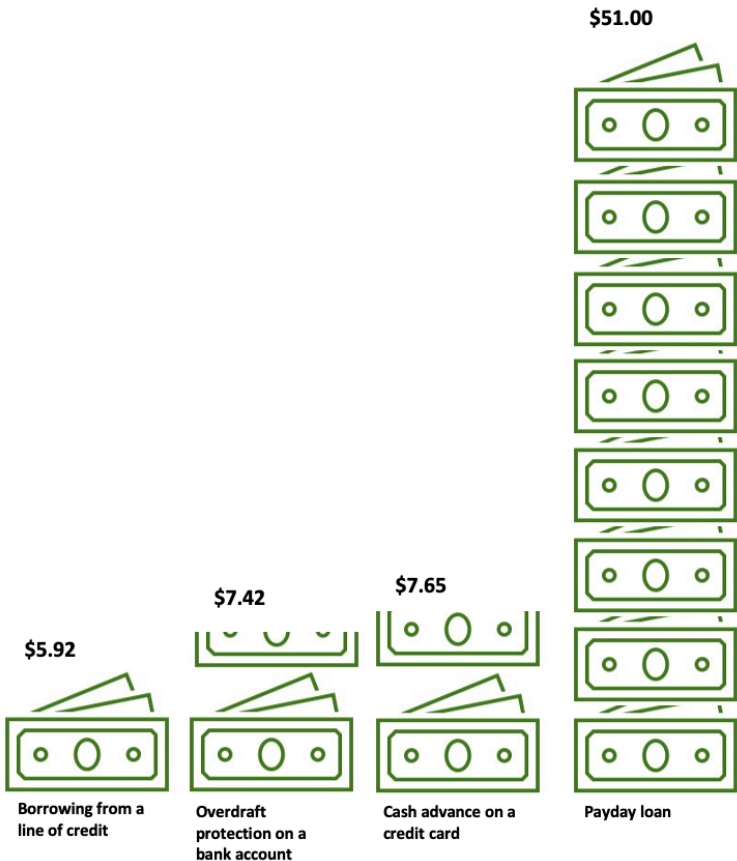


Figure 1.0 Illustrated here is the cost of a payday loan compared to a line of credit, overdraft protection on a

chequing account, and a cash advance on a credit card (based on a \$300 loan for 14 days). (Source: Financial Consumer Agency of Canada)

## Family and Friends



Image generated using the prompt “create an image of Family and Friends,” sourced from OpenAI, 2025.

For a lot of people, family is often their first lender, though we rarely think of our parents/guardians as being our lender. Often, parents/guardians are a young person’s first co-signor as they take their first steps into adulthood. Family members commonly help with buying a car or a first home. Friends can also be a source of assistance for individuals with cash flow issues. For most people, the challenge that comes with borrowing money from family or a friend is that it can severely hurt the relationship if things go wrong and the debt

cannot be repaid.

Worldwide alternate types of credit that exist.

Lender's need to be aware that internationally, there are other forms or approaches to credit that exist. In a diverse country like Canada, a lender can encounter clients that have very different experiences with the borrowing of money and lenders should try to understand their clients perspectives.

There are a variety of lending that exist globally; for the purposes of this course we are going to explore the following:

1. Microfinance
2. Community-Based Lending
3. Islamic Finance
4. Peer-to-peer (P2P) Lending
5. Crowdfunding
6. Informal Lending Networks
7. Social Impact Bonds
8. Social Credit

1. Microfinance



Image generated using the prompt “create an image of Micro Finance,” sourced from OpenAI, 2025.

Microfinance, or microcredit, refers to a specialized banking service catering to low-income individuals or groups, primarily in regions with limited access to traditional financial services. The aim of microfinance is to empower individuals and groups by providing them with opportunities to generate wealth and attain self-sufficiency (Investopedia, 2023). Microfinance institutions offer loans ranging from small amounts, as low as \$50 to under \$50,000, tailored to the specific needs of their clients (Investopedia, 2023). In addition to microcredit, these institutions may also provide a range of other banking services to support financial inclusion and economic development.

## 2. Community-Based Lending



## 2. Community-Based Lending

Image generated using the prompt “create an image Community-Based Lending” sourced from OpenAI, 2025.

Community-based lending models, such as rotating savings and credit associations (ROSCAs) or tontines, involve a group of individuals pooling their funds and taking turns receiving loans. This approach relies on trust and social connections within the community (Kabuya, 2015). This form of lending can be found in communities and regions where traditional banking systems do not exist. The unique arrangement brings together individuals who ultimately trust each other to accumulate savings and share their life experiences, further building that sense of community. Often this will lead to small flexible loans being provided for group

members for investment, consumption, and or other emergencies (Kabuya, 2015).

### 3. Islamic Finance



Image generated using the prompt “create an image of Islamic Finance” sourced from OpenAI, 2025.

According to the Bank of England, Islamic Finance adheres to the moral principles of Islam and encompasses various aspects of financial management, including savings, investments, and home financing (Bank of England, 2022). We will look at the lending aspect of Islamic Finance for this course. In Islamic religious practice, the concept of *riba*, or usury, is strictly forbidden, even at low-interest rates, as it is deemed illegal and unethical (Hayes, 2022). According to Ismail Mustafa, a Wills Associate and Team Lead at Islamic Finance Guru, *Riba* is

commonly translated to ‘interest’ or ‘usury’ in English and is a charge for using another’s money (MUSTAFA, 2021).

The approach taken in Islamic Finance is quite complex, and there are different models. Below are four methods simplified:

1. Profit-Sharing Contracts: Lender provides funds; borrower contributes expertise or labour. Profits and losses are shared based on a ratio (Mudarabah and Musharakah). (Hadizada & Nippel, 2022)
2. Murabaha: Lender buys an asset and sells it to the borrower at an agreed price with a profit margin. Repayment over an agreed period. (Financial Islam, 2023)
3. Ijarah: Lender leases the assets to the borrower for a specified period, predetermined rental payments. In ownership with a lender, the borrower enjoys the benefits and purchase options possible. (Blossam, 2020)
4. Istisna’a: Contract for financing construction or manufacturing of specific assets. The borrower makes payments during construction, and assets are delivered upon completion. (Law Insider, 2023)

A lender in Canada needs to be aware that Islamic Finance is offered in Canada; you may refer your clients to such a financial company to best suit your client needs. It is recommended that the lender researches their community to see what options may be available for their clients.

#### 4. Peer-to-peer (P2P) Lending



#### Peer-to-PeP) Lending



Image generated using the prompt “create an image Peer-to-peer lending” sourced from OpenAI, 2025.

Peer-to-peer (P2P) lending, also referred to as social lending or crowd lending, has emerged as a popular alternative method of obtaining loans directly from individuals, bypassing traditional financial institutions. P2P lending platforms, which have gained significant traction since their inception in 2005, connect borrowers and lenders, allowing them to engage in direct transactions without intermediary banks. (Investopedia, 2023). It is important to note that crowd lending is not the same as crowd funding, this will be discussed later on in this chapter.

## 5. Crowdfunding



Image generated using the prompt “create an image of Crowd Funding ” sourced from OpenAI, 2025.

The European Commission defines crowdfunding as a way of raising money to finance projects and businesses. Enabling fundraisers to collect money from a large number of people via online platforms (European Commission, 2023).

Typically crowdfunding involves individuals or organizations seeking financial support for a specific project, business venture, or cause. It allows entrepreneurs, artists, nonprofits, and others to access capital and engage with a broader community of potential supporters. Countries such as Canada, the U.S., the U.K., China, Germany, and Australia have prominent use in their countries of crowdfunding.

Crowdfunding exists globally and continues to expand in many other countries as well.

## 6. Informal Lending Networks



Image generated using the prompt “create an image of Informal Lending Networks” sourced from OpenAI, 2025. Informal lending networks, informal finance, or informal credit systems refer to financial arrangements and practices outside formal banking institutions. These networks typically operate within local communities or social groups and involve individuals lending and borrowing money among themselves. Here are some key characteristics of informal lending networks:

- Trust-based relationships: Reliance on trust, and social connections.
- Flexibility: More flexible repayment terms than formal

institutions.

- Customized terms: Loan terms tailored to individual needs.
- Limited documentation: Less reliance on formal paperwork.
- Social cohesion and reputation: Reputation influences access to loans.
- Local knowledge and understanding: Understanding of local dynamics and norms.

Informal lending networks are standard where formal financial services are limited or traditional banking requirements are challenging.

Informal lending networks are found in various contexts, including:

1. Emerging markets, particularly in rural areas and low-income communities.
2. Immigrant communities face barriers to formal financial services.
3. Informal economies with significant informal business activities.
4. Marginalized or underserved communities in both developed and developing countries.
5. Social and cultural organizations, religious groups, and community-based associations.

The form and prevalence of these networks can vary based on a region or community’s specific socio-economic and cultural factors.

## 7. Social Impact Bonds



Image generated using the prompt “create an image of Social Impact Bonds” sourced from OpenAI, 2025.

Social impact bonds represent a unique collaboration between the public and private sectors, where social services are funded through contracts that emphasize performance. Here, the necessary capital for expanding high-quality service providers’ work is furnished by impact investors. If the project delivers beneficial public outcomes, the government reimburses these investors (Social Finance, 2023). Regardless of the aim, be it assisting impoverished mothers to

have healthy childbirth, aiding immigrants and refugees with job training, or refurbishing homes, social impact bonds shift the risk from public to private sectors. Furthermore, they bring project partners together to realize a significant impact (Social Finance, 2023).

How social impact bonds work (Social Finance, 2023):

1. The government identifies a social issue and partners with an intermediary, like Social Finance, and reputable service providers to address it.
2. Social Finance coordinates with the government and provider to structure the project and raise funds from impact investors.
3. The provider delivers services to the target group, with Social Finance offering continuous support, including performance and financial management.
4. Delivering high-quality services significantly improves the lives of the target population.
5. An independent evaluator measures the project's success using preset metrics. If successful, the government repays investors based on the level of outcomes achieved.

In January 2018, Social Finance stated that social impact bonds reached a global mass: 108 projects launched in 24 Countries (Social Finance, 2023). Countries, where social impact bonds can be found are the U.K., the U.S., the Netherlands, Australia, Israel, Canada, and many other

European countries (Katz, 2018).

## 8. Social Credit



Image generated using the prompt “create an image of Social Credit” sourced from OpenAI, 2025.

Social credit refers to a concept where individuals or businesses are assigned a numerical score representing their “trustworthiness” or “reputation” based on their behavior, actions, and various other factors. The most well-known implementation of this concept is China’s Social Credit System, which is intended to standardize the assessment of citizens’ and businesses’ economic and social reputation, or “credit.” China’s social credit system consists of various databases and programs designed to evaluate the reliability of individuals, businesses, and governmental bodies. Each participant receives a social credit rating, with those achieving

high scores reaping benefits while those with low ratings face sanctions (Lee, 2020).

How does it work?

First proposed by China's State Council in 2014, the social credit system monitors and evaluates the trustworthiness of individuals, businesses, and government entities using various databases. It assigns a social credit score, rewarding high scorers and penalizing those with low ratings. The system, managed by China's National Development and Reform Commission, the People's Bank of China, and the courts, mainly gathers data from financial, criminal, and government records. Companies and individuals with low trustworthiness may face restrictions in areas like loans, travel, and education (Lee, 2020).

Summing Up Worldwide Alternate Types of Credit That Exist

These approaches to credit are just but a few that exist. A lender needs to know how credit is approached in other countries to work with their clients to help them learn the Canadian credit system. By understanding the differences, a lender can make the experience of borrowing for a client new to Canada much more comfortable.

Why Do Clients Need Credit?

It may seem that there are many reasons why a client could need access to credit, but we break it down, there are really four reasons:

1. Convenience
2. Payment deferral
3. Income shortfalls
4. Debt consolidation

Let's look at these reasons and determine the advantages and disadvantages of each.

## 1. Convenience

One main reason a client seeks out credit is convenience or to make their lives easier now rather than waiting until later. Convenience allows for instant gratification. While a credit card is convenient, there are also disadvantages associated with this convenience.

### **Advantages**

- Credit cards can have no interest charges when the outstanding balance is paid on time (not including cash advances).
- The monthly statement provides a convenient summary of expenses.
- Credit builds a person's credit rating.

### **Disadvantages**

- The interest rate charged on unpaid balances is often much higher than on other borrowed funds (some credit cards do have varying interest rates).
- Convenience can encourage impulse purchases, leading to an increased debt load.
- The convenience of credit encourages some people to accumulate excessive debt.

## **2. Payment Deferral**

The majority of Canadians cannot purchase their first home outright in cash. They need to borrow money to make the goal of home ownership a reality. It is a costly reality, with the home costing much more over a 25-year period.

### **Advantages**

- The opportunity to have goods/services immediately.
- It allows consumers to make reasonable purchases that exceed their current cash situation (e.g., car or house).

### **Disadvantages**

- Purchases end up costing more because of interest and other charges.
- A repayment schedule reduces cash flow. Credit can reduce the ability to buy goods and services in the future.

## **3. Income Shortfalls**

Occasionally, a client's income can fluctuate, and they need assistance covering these income shortfalls. Having access to

credit during the times when an individual is short on income is helpful, but it will be necessary to repay the debt at a later date—with interest.

### **Advantage**

- Credit allows clients to meet expenses during periods of little or no income.

### **Disadvantage**

- Interest must be paid regardless of whether anticipated income is actually received.

## **4. Debt Consolidation**

According to Statistics Canada, in 2019, the debt-to-income ratio was 181.1%, meaning that for every dollar coming in, Canadians are paying \$1.811 out (Statistics Canada, 2022).

Debt consolidations will be a reality for many years to come until Canadians can get a handle on the debt load they carry. When clients are feeling overwhelmed and getting behind on their debt, they may look to consolidate their debts to provide payment relief.

### **Advantage**

- Combined payments result in lower interest costs, and combined payments free up cash flow for investment purposes.

### **Disadvantage**

- Individuals with poor personal finance-management skills may consolidate their debts, but still incur additional debt.

# The Role of the Lender

A lender is an individual who makes funds available to a person or business with the expectation that the funds will be repaid according to the agreed-upon terms of a contract (Barone, 2022).

A lender can have many different roles and work for many different types of lending institutions. For this course, the lender described will be someone who works for a financial institution in Canada.

Successful lenders have a solid understanding of all their institution's lending products and services. Strong product awareness assists the lender in determining the appropriate solution for their client. A lender should review each client's unique financial situation. Remember, no credit deal is ever precisely the same. A lender can expect to encounter challenges when addressing client situations; the lender will often have to propose multi-step solutions to help a client achieve their goals. Moreover, a lender needs to understand that not all of their credit deals will be completed successfully, leading to difficult client conversations. Managing client expectations is a skill that all lenders need, and it is important to recognize that “no” right now does not mean “no” forever. A lender can work with their client to help them re-establish themselves financially. Eventually, the answer will become “yes,” and the client can realize their financial goals. A lender also needs to have a good understanding of risk mitigation.

This course will teach the requirements for putting together a proper credit deal with risk mitigation concepts applied appropriately.

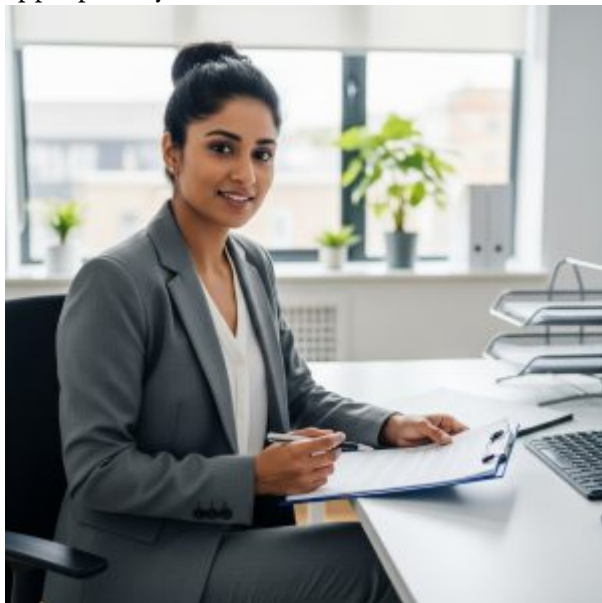


Image generated using the prompt “create an image of a Lender” sourced from OpenAI, 2025.

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2.

# CHAPTER 2 – LENDING PRODUCTS AND SERVICES

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Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- the different types of revolving accounts.
- the different types of installment accounts.
- the importance of time value of money

lending calculations.

- the different types of consumer loan

## Revolving Accounts

Revolving accounts

allow clients continuous credit unless a payment is late or the account is over the established credit limit. The credit limit is set by the financial institution, and they determine the credit limit through their lending process if they are willing to extend credit to a client. Financial institutions lending processes can vary from one bank to another. Their determination is based on a thorough analysis by a lender. Credit gives clients the ability to make ongoing purchases. Examples of revolving accounts include credit cards, personal lines of credit, and home equity lines of credit.

## Credit Cards



Image generated using the prompt “create an image of a Credit Card” sourced from OpenAI, 2025.

Credit cards are used by clients to make everyday purchases, and they will often provide clients with an “emergency” source of funds when they have no access to cash.

Credit card companies offer additional benefits and features to attract clients to their card, such as travel points or cash back on items like gas or groceries.

Some common credit cards include Visa, Mastercard, and

American Express. Interest rates charged on credit card accounts can vary from card to card.

Repayment terms on credit cards usually range between 21 and 30 days after a billing cycle. Credit cards offer a grace period, which is a set period of time during which interest on the credit card debt is not accruing, and penalties are not being applied (O’Connell, 2019).

### **Lender Calculation for Credit Cards**

Lenders calculate monthly minimum payments as 5% of the outstanding balance of the credit card.

*Example:*

For a Visa balance of \$5500.25, the minimum payment would be calculated as:

$$\$5500.25 \times 0.05 = \$275.01$$

## Overdraft Protection



Image generated using the prompt “create an image of Overdraft Protection” sourced from OpenAI, 2025.

Overdraft protection (ODP)

is a “safety net” offered to clients when they have insufficient funds in their bank account. This limit is set by the bank/ financial institution.

ODP protects a client’s account when transactions are being processed, and there are not sufficient funds to cover these items. Transactions typically include the following:

- debit purchases;

- bill payments and pre-authorized debits;
- cheques;
- withdrawals; and
- transfers between bank accounts.

ODP protects clients from having non-sufficient funds (NSF) fees charged on their accounts. When there is no approved ODP in place, these fees can be up to \$50.00 (Financial Consumer Agency of Canada, 2022). Clients are required to bring their account to a positive position **at least one day** over a 30/60/90-day period. This is to ensure that this source of credit is not abused as a perpetual source of funds. Lenders do not calculate this as a monthly payment because the interest charged each month is absorbed by the bank account each month.

## Secured Lines of Credit



Image generated using the prompt “create an image of a Secured Line of Credit” sourced from OpenAI, 2025.

With a Secured Line of Credit (SLOC), a client pledges their assets to the bank/financial institution. While the SLOC is active, these assets (i.e., GICs, CSBs, MFs) cannot be liquidated. If clients do not repay the amount owed on the SLOC, they risk losing the asset(s) that was pledged at the time of application.

### **Lender Calculation for SLOC**

Lenders typically calculate these payments as interest only. The interest rate is usually set at the prime rate.

*Example:*

A SLOC has a balance of \$25,000 at 2.85%. The interest ( $I=prt$ ) would be calculated as:

$$0.0285/365 * 30 \text{ (number of days in the month in question)} * \\ \$25,000 = \$58.56$$

If the client chooses to make a larger payment, the additional amount is applied to the principal.

## Unsecured Lines of Credit



Image generated using the prompt “create an image of a Unsecured line of credit” sourced from OpenAI, 2025.

An Unsecured Line of Credit (ULOC) is an account that is approved based on a client’s financial situation at the time of application; there is no need for assets to be pledged. An unsecured line of credit is similar to a credit card, but it will have a higher limit. Typically, limits start at \$10,000 and can go as high as \$100,000. Clients who qualify for an unsecured line of credit are considered to have strong credit worthiness.

### **Lender Calculation for ULOC**

Lenders calculate minimum payments as the greater of \$50 or 3% of the outstanding balance.

*Example:*

An unsecured line of credit with an outstanding balance of \$15,485.52 would be calculated as:

$$\$15,485.52 * 0.03 = \$464.57$$

## Home Equity Line of Credit



Image generated using the prompt “create an image of a Home Equity line of credit” sourced from OpenAI, 2025.

With a Home Equity Line of Credit (HELOC), a client pledges real property as collateral to the bank/financial institution. An advantage of a HELOC to a client is that it offers the flexibility of having revolving and fixed account features. A HELOC can be financed up to 80% of the market value of the client's home. Of that 80%, a maximum of 65% is a revolving line of credit; the other 15% must be in a fixed-term mortgage (Government of Canada, 2023). HELOC lending is discussed in greater detail in Chapter 6.

**[Table 2.1] Loan to value calculation. (Source: Professors Carla Van Horne and Rosanna Anderson, NAIT)**

<b>Value of the Home</b>	Potential maximum of HELOC and regular mortgage amount based on the appraised value (maximum 80% Loan To Values)	<b>LESS</b> balance owed on mortgage	<b>Maximum credit limit on HELOC</b>
\$450,000	\$360,000	\$200,000	<b>\$160,000</b>

*Since the example provided shows \$160,000 is less than 65% of the value of the home, the entire \$160,000 will be revolving.*

### **Lender Calculation for HELOC**

Lenders typically calculate these payments as interest only. The interest rate is usually set at the prime rate plus a value determined by the financial institution.

*Example:*

A HELOC has a rate of prime plus 1% where prime is 2.25%; the outstanding balance is \$55,575.96. The lender would calculate the minimum payment as follows:

Step 1:  $(0.0325 * \$55,575.96) = \$1806.22$

Step 2:  $\$1806.22/365 = \$4.95$

Step 3:  $\$4.95 * 30 = \$148.50$  minimum payment due

## Instalment Accounts



Image generated using the prompt “create an image of a Installment Account” sourced from OpenAI, 2025.

Instalment accounts are often used to finance large ticket items (e.g., cars, recreational vehicles, or furniture.) They are usually offered by retailers or dealerships. Payments are a blend of principal and interest, depending on the number of payments and compounding periods.

## Temporary Loans

With a temporary loan, payment may be made in full (demand loan) or in instalments (instalment loan), depending on the agreement. These types of loans can be used for debt consolidation, the purchase of a car, travel, investments, etc. Financial institutions offer this type of loan most frequently. The payments of instalment loans blend principal and interest based on an interest rate determined by the bank with specified compounding periods and scheduled payments.

## Demand Loans

A demand loan can be an interest-only type of credit. The institution has the right to demand payment at any time.

A demand loan may be paid in several ways:

- equal amounts of principal plus interest based on the declining balance of the loan

- the full amount of principal and interest on demand in the future
- interest payments only with the principal repaid in a lump sum

Interest may be fixed or variable and is based on the prime rate. This type of credit is becoming increasingly uncommon for consumers and is reserved for specific transactions, such as bridge financing for a business.

**An example of how demand loans operate:** A bakery chain wants to buy a competitor. They secure a \$500,000 demand loan from ABC Bank with a variable interest rate. The bakery owner pays interest monthly and repays the principal as a lump sum later. The bank can demand full repayment anytime. The bakery owner intends to pay the principal from the profits of the acquired business. This scenario illustrates how demand loans can serve as bridge financing.

A bank may demand repayment on a demand loan for a variety of reasons, including:

- Risk mitigation: If the bank perceives increased risk in the borrower's ability to repay—perhaps due to changes in their financial circumstances, such as a significant loss in revenue, bankruptcy, or other adverse economic events.
- Regulatory requirements: To meet specific regulatory

requirements or risk management standards.

- Market conditions: Changes in market conditions, like a sharp increase in interest rates or an economic downturn, might make the loan too risky to maintain.
- Internal policies: To meet internal liquidity needs or capital requirements based on changes in the bank's loan policies.

## Mortgage Loan



Image generated using the prompt “create an image of a Mortgage Loan” sourced from OpenAI, 2025.

A mortgage loan is a long-term lending of money secured by real estate. There are many payment options. The maximum

length of amortization in Canada is 25 years. Clients can choose a term best suited to them. Terms can be 1, 3, 5, or 10 years, all with varying differences in interest rates. Mortgages can be obtained through a financial institution or a mortgage broker. Mortgage lending is discussed in greater detail in Chapter 10.

## Time Value of Money Review

Lenders need to know how payments are calculated to ensure all calculated values are correct. If the values in an application are incorrect, the result could lead to deals being approved that should not be approved or deals being declined when they should be approved.

The Time Value of Money (TVOM) is a very important tool in lending. All students must be confident in using the TI BAI Plus calculator. The instruction book for your calculator is very useful if you require a refresher on TVOM. There is also a calculator tutorial available toward the end of this chapter.

Lenders need to understand how loan payments are calculated and how loans are amortized. If money received today is invested, its future value will be larger than its present value.

*Example:*

The future value of a \$100,000 investment in one year if the interest is 7%:

$$PV=100,000 \quad n=1 \quad i=7 \quad PMT=0 \quad COMP=FV = 107,000$$

## Periods per Year Setting

To check the current setting, press 2nd F p/y.

The display shows the setting for periods/year. The calculator comes preset at 12 periods per year; that is, it assumes calculations will be done on a monthly basis.

*“p/y” is the number of payments per year.*

## Compounding Periods per Year

To check the current setting, press 2nd F c/y.

The display shows the setting for compounding periods/year. The calculator assumes that p/y and c/y will be equal.

*“c/y” is the number of compounding periods per year.*

Most loans are payable in monthly installments, and interest is compounded monthly. Therefore, 2nd F p/y 12 enter down c/y 12 2nd F QUIT.

It is important to reset p/y and c/y for every calculation!

## APR vs. EAR

Interest is usually quoted as the “annual percentage rate” (APR). However, if it is compounded more than once per year, we need to know the “effective annual rate” (EAR).

*Example:*

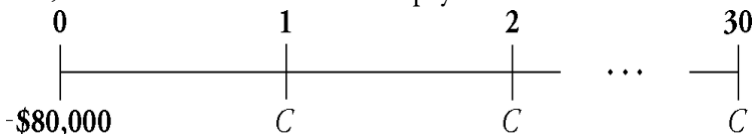
The bank lends money at 6% APR. If the loan is payable monthly and interest is compounded monthly, the EAR can be found by:

2nd F ICONV nom=6 enter down c/y = 12 eff = CPT = 6.168%

The EAR > APR because of compounding; interest is charged on interest.

*Example:*

A firm plans to buy a warehouse for \$100,000. The bank offers a 30-year loan with equal annual payments and an interest rate of 8% per year. The bank requires that the firm pay 20% of the purchase price as a down payment, so the firm borrows only \$80,000. What is the annual loan payment?



[Figure 2.6] A visual representation of the example described

above. (Source: Professors Carla Van Horne and Rosanna Anderson, NAIT)

Note that payments are annual, and it is assumed that compounding matches payments. In this case, the EAR = APR:

$$p/y\ 1\ c/y\ 1\ \mathbf{PV-80,000\ n30\ i8\ FV0\ comp\ PMT = \$7,106.19}$$

If payments were made monthly:

$$p/y12\ c/y12\ \mathbf{PV-80,000\ n360\ i8\ FV0\ comp\ PMT = \$587.01}$$

Note that n indicates the total number of payments in the loan schedule. In this case, EAR > APR. The calculator automatically compounds interest.

We can find the balance outstanding and interest paid to date by using the AMORT key.

*Example:*

After 18 payments have been made:

$$2^{nd}\ F\ AMORT\ p1 = 1\ p2 = 18$$

$$Bal = \$78,977.01$$

$$Prn = \$1,022.96$$

$$\text{Int} = \$9,543.25$$

Where  $p_1$  and  $p_2$  are the range of payments.

*Canadian mortgages* are set up with semi-annual compounding, regardless of the number of payments per year. A 30-year mortgage of \$400,000 at 4% APR has the following payment:

$$p/y \ 12 \ c/y \ 2 \ PV \ -400,000 \ n \ 360 \ i \ 4 \ FV \ 0 \ comp \ PMT \ 1902.07$$

In 5 years (after 60 payments), the balance owed will be \$361,597.29.

Payments can be made bi-weekly, or 26 times per year, resulting in a payment of \$877.10.

$$p/y \ 26 \ c/y \ 2 \ PV \ -400,000 \ n \ 780 \ i \ 4 \ FV \ 0 \ comp \ PMT \ 877.10$$

**Complete review activity in Brightspace.**

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3.

# CHAPTER 3 – CONSUMER CREDIT ANALYSIS: THE FIVE CS OF CREDIT

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Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- the five Cs of credit.
- how to apply the five Cs of credit to a lending application.

- how to identify the common red flags in a lending application.

Consumer credit analysis is the process in which a lender collects required information to determine a client's creditworthiness.

Banks and financial institutions write loans and mortgages every day to be paid over a term length agreed upon with the client. The challenge for lenders is that they cannot predict the future. The decision to grant credit is based on the information provided at the time of the credit application. Due diligence on the part of the lender is required to ensure a deal is sound, well constructed, that all precautions were taken, and that any indicated risks were properly mitigated.

When a loan or mortgage goes into default, the credit files for that loan are reviewed to ensure that all proper processes and procedures were completed at the time of the credit application. Financial institutions prefer to minimize loan losses, as their goal is to create value for their shareholders. Significant loan losses do not sit well with shareholders. Auditors can also review credit files as part of normal security processes; they are ensuring all necessary policies and procedures are being followed. A lender should always strive to

submit a solid credit file; they want to ensure their credit deals do not get called into question.

Lenders have long used a framework called the **five Cs of credit** to help them analyze a client's situation to determine their credit worthiness. Lenders use this framework to help predict their client's future behaviour. Note that there are some variations of the five Cs of credit; the authors have chosen the framework commonly used for consumer credit in Canada.

# The Five Cs Framework: CHARACTER/CAPACITY/ CAPITAL/ CREDIT/COLLATERAL

## CHARACTER



### **Stability of Employment**

A client's time at their employer is critical to the entire credit application. The lender should always ask, "Will we get repaid?" Clients should have three years with the same employer because this indicates stability. However, there could be reasons for a client not meeting the three-year benchmark

for employment. Lenders need to review and determine if the client is still in the same line of work. If not, the lender will need to determine the reason for the career change. Did they change careers to improve their prospects and life? Did they just graduate university and land their first job? All this information is critical for the credit file. If a client does not have three years of employment stability, this is concerning and could be considered a red flag.

### **Time at Residence**

The benchmark here is to have three years at the same residence. Three years plus shows stability and is preferred in lending. If the client has moved multiple times and does not have three years at a residence, the lender will need to ask the client for an explanation. Some reasons can be justified and, therefore, mitigated. The rationale needs to be included in the credit submission.

### **Owning versus Renting**

Lenders view owning a home as an excellent sign of credit. It shows the client was able to qualify for a mortgage in the past and is now maintaining a mortgage.

### **Educational Background**

A client's educational background is something that lenders review as it can impact their ability to earn income. It should

be determined if a client's education aligns with their career choice. If it does, it indicates that the client believes in investing in their future.

### **Asset and Liability Mix**

The status of a client's financial situation at a given point in their lives indicates a client's financial maturity. For example, a client is in their 30s and has established a good mix of assets and liabilities. In the case of this client, their financial situation demonstrates their financial maturity. Lenders like to see that clients have established RRSPs, TFSAs, and other investments while also balancing their debt load.

## CAPACITY



Capacity is defined as the financial ability to pay debts when they are due. For capacity, lenders want to see if a client’s debt ratios are in line and determine if the client has stability with employment and their ability to earn income.

*Can the client repay this debt?* To determine this C of credit analysis, the lender will analyze the client’s information, calculate their income versus debt, and use debt ratios to determine their ability to pay back their debt.

**Gross Debt Service Formula:**

Mortgage/Rent + Taxes + ½ condo fees + heat

Gross Monthly Income

(Source: Professor Carla Van Horne, NAIT)

**GDS cannot exceed 39%.**

Total Debt Service Formula:
$\frac{\text{Mortgage/Rent} + \text{Taxes} + \frac{1}{2} \text{ condo fees} + \text{heat} + \text{other debt obligations}}{\text{Gross Monthly Income}}$

(Source: Professor Carla Van Horne, NAIT)

**TDS cannot exceed 44%.**

**Note:** GDS and TDS ratio guidelines can vary between financial institutions based on their lending criteria. For the purposes of this course, we will use the above ratio guidelines.

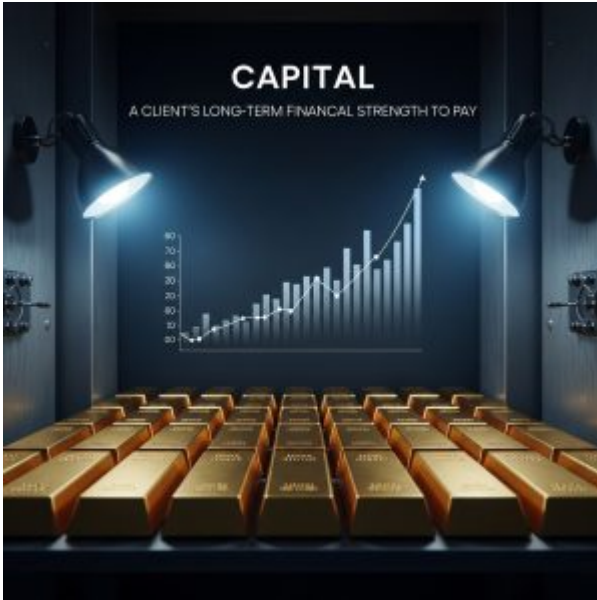
Lenders calculate a client's TDS ratio prior to a new loan request. This helps the lender determine the client's current situation and if the client has the capacity to take on more debt. If their initial ratio exceeds the required limit, the lender should review the client's situation to determine if a debt consolidation would help the client's capacity. Debt consolidation could help achieve the client's initial credit request.

Financial institutions have a required calculation they use to determine the value for heat. Some institutions calculate it as  $0.06 \times$  the square footage of the house. In this course, we will use a flat value of \$120 for our debt ratio calculations. Property tax is typically retrieved from a client's property tax statement, but for course purposes, the value for property tax

will be provided in the cases and activities found throughout the course.

**Note:** If a client indicates their rate of pay is about to change due to a raise, the lender can only use what can be verified. Current income would be used until the new pay rate can be shown (per the income verification requirements).

## CAPITAL



Capital is defined as a client's long-term financial strength to pay. The lender considers all of the client's assets and liabilities. The lender will ask the client for a list of the assets financial

institutions deem acceptable for lending purposes. Assets considered acceptable to a financial institution are:

**[Table 3.1] List of acceptable assets. (Source: Professor Carla Van Horne, NAIT)**

<b>Real Estate</b>	<b>Automobiles</b>	<b>Investment Accounts</b>	<b>Accounts</b>
Lender needs client's primary residence and any other properties (recreational/rental)	Year/Make/Model	Term Deposits, RRSPs, GICs, TFSAs, Mutual Funds, Discount Brokerage Accounts, Pensions	Chequing and Savings Accounts

The lender will collect all of the liabilities in the client's name. What if a client neglects to share a liability and it is discovered later by reviewing their credit bureau report? In this case, the lender will need to determine if this was an oversight by the client or if they intentionally withheld the information.

**[Table 3.2] Liabilities are collected to determine net worth. (Source: Professor Carla Van Horne, NAIT)**

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Mortgages

Home Equity Line of Credit

Unsecured Line of Credit

Loans (RRSP, Student Loans, Renovation Loans, Other)

Credit Cards

---

When the lender assesses the client's assets to liabilities, they will determine the client's capital position. This is done by determining the client's net worth position. The net worth position should correlate to the client's age and employment. A higher net worth demonstrates prudence and reinforces character. If a client presents with a negative net worth, the lender must mitigate this position. If the client is young and establishing themselves, it is expected that they will have a negative net worth as they build up their asset base. However, if a client has a negative net worth but is older and should be established, the lender needs to look into the client further.

CREDIT



In the five Cs, credit refers to how the client chooses to use credit. Consider the client's purpose for the credit being requested. Also, look at their current use of credit and the availability of existing credit. This C is usually evaluated by using a credit bureau supplied by a *credit reporting agency*. The two main credit reporting agencies in Canada are Equifax and TransUnion.

**[Table 3.3] Things to consider when collecting information from credit bureaus. (Source: Professor Carla Van Horne, NAIT)**

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The cost of using credit reporting agency information; these costs can vary.

The sources of information. Are they accurate?

NSFs, collections, and payment history

Credit bureaus do not make assessments of anyone's capacity to handle credit.

Credit reporting agencies merely collect and sell information.

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**[Table 3.4] The advantages and disadvantages of credit bureaus. (Source: Professor Carla Van Horne, NAIT)**

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**Advantages**

**Disadvantages**

Available immediately

Some information may be inaccurate, missing, or old

Low bias – # of creditors

No information on new businesses/people

Good history available

Cheaper to get a report than to get all information

---

You can further review the topic of credit bureaus by clicking the following link and reviewing the document [Understanding Your Credit Report and Credit Score](#). Choose “Continue to publication” to see the document.

## COLLATERAL

## COLLATERAL

Collateral is a major consideration in the process of granting credit. Collateral is often used to mitigate the level of risk in a deal. The client is asked to pledge an asset to the lender to enhance the promise to repay. If the client is not able to follow through on the loan agreement, the asset is seized and liquidated to satisfy the debt. Collateral represents something *tangible* that can be pledged for a loan. *Security* is a claim (or right) that the borrower has voluntarily assigned to the lender to reduce the lender’s risk. A co-signature of a guarantor represents security but not collateral.

### **The Personal Property Security Act (PPSA)**

- The Personal Property Security Act (PPSA) brings together, under one roof, legislation that was previously embodied in several acts. Who has title to the asset is now irrelevant.

- It encompasses the various types of security documents that create **security interests in property, except real estate**, which is registered with land titles (e.g., PPSA does not cover collateral mortgages)
- **PPSA includes** chattel mortgages, conditional sales, floating charges, pledges, trust deeds, assignment (securities), and certain consignments.
- A bank or seller must register a **financing statement** with personal property.
- Registry is required to maintain a security interest in the goods.
- A security interest is NOT enforceable against a third party unless the debtor has signed the security agreement that has a description of the collateral (with serial number).
- One security agreement can create a security interest for part or all of the debtor's personal property, both present and future.

## How Would You Pledge the Following as Collateral for a Consumer Loan?

Value of the security vs. amount of loan.

Concerns when realizing your security?

## Seizing – Claiming – Liquidating.

The type of collateral used for a credit file has implications for the interest rate. An asset that is considered of better quality and liquidity could result in a reduction of the interest rate.

### 1. Vehicle



- *Down payment? Age of vehicle significant?* A new vehicle is considered to be less than four years old. A used vehicle is anything older than four years of age.
- The ability to use an older vehicle as collateral depends on the strength of the deal.
- It provides commitment by the debtor as an incentive to

pay.

## 2. Property



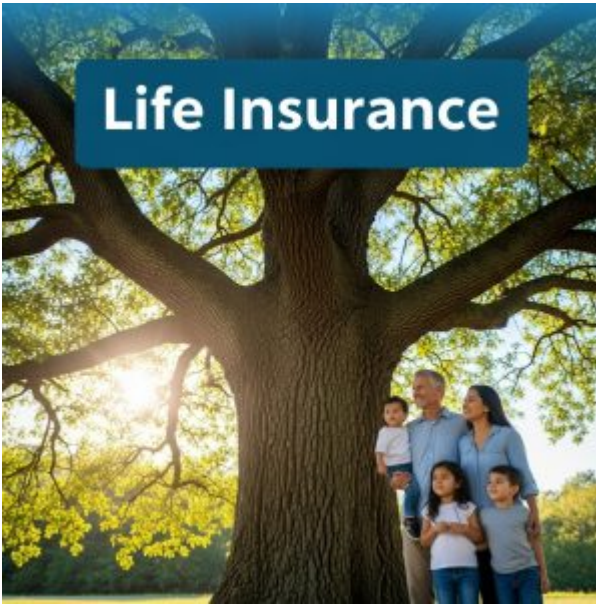
- residential property
- first mortgage
- second mortgage (total loan/value < 80%)
- recreational property (location)

### 3. Government Bonds



- note value changes
- 70% value

## 4. Life Insurance.



- Must have a cash surrender value
- A significant amount of paperwork
- SDB

## 6. Mutual Funds



- Money Market – 100% value
- Bond Funds – 70% value
- Equity Funds – 50% value

## 7. Stocks



- Blue Chip – 50% of value
- Penny Stock – too risky

## 8. Term Deposits/GICs

- 100%

*Usually only allowed as collateral if the GIC/Term Deposit is at the same financial institution. The Advisor will take a statement of the GIC/Term Deposit, and register a message on the banking system to indicate that the investment is held as collateral.*

## Not Considered Collateral

- Personal guarantees or co-signors are not considered collateral but can be added to a credit file to strengthen the deal.
- RRSPs are protected by bankruptcy legislation.
- Stereo equipment/computer equipment/camera lenses/furniture/jewelry depreciate quickly and are difficult to seize and liquidate.

## Questions for the Lender

**How much security does the bank need?** It depends on the liquidity and value of the security/collateral.

**When can the financial institution lend unsecured?** The following reasons will allow a financial institution to issue an unsecured loan: high net worth (20%), high income, an excellent banking relationship, and when the loan is not for consolidation.

**What happens if the bank takes too much security?** If a loan is over secured, the financial institution can't keep liquidation value in excess of the debt owed.

## Red Flags in Lending



As a lender gets more experienced in completing a client's credit analysis, they will be able to identify certain factors that are considered red flags. These are things that the lender should watch out for and pay close attention to.

### Signs of Credit Risk

#### **Undisciplined Spending Habits**

Look at the credit bureau to see the type of credit requested in the past or review the client's bank account statements to identify trends. Beware of clients who request a debt

consolidation loan to pay off credit cards and then re-open or re-apply for credit cards and start accumulating more debt.

### **Unstable Employment**

If a client has instability in their employment (multiple jobs not in the same industry) or frequent job changes, the loan may not be repaid. The risk is higher for individuals who are unemployed, seasonal, or on government assistance. The lender must ask questions about the client's unstable employment when determining the client's ability to repay the debt being requested.

### **Client Misrepresentation**

Clients may provide incorrect or incomplete information. They may inflate their income or neglect to disclose all of their debt. Sometimes this is unintentional; however, if it is determined that this is deliberate, the credit request should be declined.

### **Negative Net Worth**

When a client presents with a negative net worth (more liabilities than assets), more scrutiny is required by the lender. The lender may need to look into assisting the client with a debt consolidation. This will allow them to start saving money and build up their net worth.

## Mitigating Risk

**[Table 3.5] Tips to help mitigate risk. (Source: Professor  
Carla Van Horne, NATI)**

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Closely conform to credit guidelines at all times.

React quickly and appropriately to changing client situations.

Keep your guard up; trust your instincts.

Do not advance inappropriate credit out of pity for a client.

Verify that all necessary client documentation is in good order.

Be alert for discrepancies and irregularities.

Investigate all irregularities thoroughly.

Document all inquiries and aspects of the investigation.

Resist a client's insistence on urgent approvals.

Treat the bank's money as you would your own.

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**Trust your instincts; intuition never lies.**

– Oprah Winfrey

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## 4.

# CHAPTER 4 – CREDIT: INVESTIGATIONS AND APPLICATIONS PART 1

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### Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- what is involved in a credit investigation.
- the importance of credit applications.
- what is required when completing a credit application.
- how financial institutions handle their credit/

lending departments.

## Credit Investigations



Credit investigations are undertaken by the lender to vet a client's ability to pay back the loan. Clients who do not meet the requirements of the investigation will likely be denied the loan.

The more complex a client's debt request, the more

information gathering will be required. Financial institutions have specific requirements that need to be determined before funds can be released to the client.

Consider the following situation:

- *Would you do the same level of investigation for a \$1,500 overdraft request as you would for a \$15,000 car loan request? Which warrants more investigation?*

## Due Diligence

Due diligence is a critical exercise in a lending transaction. It allows the lender to make an informed decision as to whether to grant credit or not and on what terms.

## Considerations in Acquiring Information

Clients should be prepared to provide information that the lender requires to investigate their ability to repay the debt being requested. Personal information is required to determine their identity, and there is information required for the credit analysis that needs to be completed.

It is important to recognize that some credit deals are high risk, meaning the likelihood of repayment is questionable. There will be deals that do not get processed. In some cases, it is

possible to mitigate the risk or modify the deal to get it approved. Risk can be mitigated by securing collateral for the loan, adding a co-signor, closing out other credit cards, or reducing the amount of money the client is requesting.

Clients should be prepared to provide the needed documentation. A lender must do their due diligence to verify that what the client has stated is, in fact, true. For example, if a client indicates that they have \$100,000 in RRSPs, the lender may need to get statements to verify that this is the case.

## Legal Authorization to Investigate

To proceed with a credit investigation, the client(s) need to sign a credit application. Their signature allows a lender to proceed with the investigation and access a client's credit bureau for the credit analysis.

# Credit Applications

## Purpose



The lender and the client need to establish the purpose of the credit request. This formalizes the request and gives the lender authorization to proceed with a credit investigation. The purpose should align with the credit being requested. For example, if a client wishes to purchase a car, they will get a car loan, not a mortgage. The purpose can provide the lender with information on the credit worthiness of the applicant. Are they making a legitimate request, and does it make sense given their current financial situation?

## Applications

The lender must verify the identity of the client. This is done by obtaining two pieces of identification and at least one piece of picture identification. Personal information required includes an address, date of birth, and social insurance number. The lender should ask questions about the information being provided. For example, if the client lives in Sherwood Park, why are they applying for credit at a branch in the west end of Edmonton? A lender must always be on guard for individuals posing as someone else to commit fraud. Remember, if something does not make sense, more questions need to be asked.

While collecting information, be careful to only discuss credit information with the applicant to whom the information applies. Privacy is important! Even with a married couple, the lender cannot provide one spouse's financial information to the other spouse. It may be necessary to have discussions with each spouse separately, even though the loan is being requested jointly. If clients provide consent to share this information, then proceed with the discussion.

## Required Information for an Application

### **Personal Contact Information**

- social insurance number
- date of birth
- citizenship status
- marital status
- email address
- primary telephone number
- permanent address (minimum of three years history is required)

### **Employment and Income Information**

- employment status (minimum of three years history is required)
- work phone number
- employer name
- gross monthly income amount and source(s) of income (all sources being considered for the loan)

### **Personal Loan Information (Loan Being Applied For)**

- loan purpose
- desired term
- loan amount
- preferred payment due date

### **Additional Documents (Required as Necessary)**

- recent pay stubs or other income verification documents
- utility bills (to verify address)
- driver’s license or social insurance number card
- consumer debt information (including mortgage or monthly rent payments)
- consumer debt information (to determine which accounts need to be paid out and closed [if necessary])
- power of attorney documentation (if one exists for the client)
- client’s asset information (for verification purposes)

## Example of a Credit Application

Most financial institutions use software to collect the data required for a credit application. Below is an example of a credit application. Note the required information the lender needs to collect.

mple of a credit application. Note the required information the lender needs to collect.

**NAITBANK LOAN APPLICATION**

AMOUNT OF LOAN REQUESTED		MONTHLY PAYMENT YOU CAN AFFORD
--------------------------	--	--------------------------------

PURPOSE OF LOAN \_\_\_\_\_

NAME \_\_\_\_\_ SIN# \_\_\_\_\_

DATE OF BIRTH \_\_\_\_\_

SPOUSE \_\_\_\_\_ SIN# \_\_\_\_\_

DATE OF BIRTH \_\_\_\_\_

ADDRESS \_\_\_\_\_ CITY \_\_\_\_\_ POSTAL CODE \_\_\_\_\_

RENT OR OWN? \_\_\_\_\_ MONTHLY PAYMENT \_\_\_\_\_

MORTGAGE BALANCE \_\_\_\_\_ MORTGAGE HOLDER \_\_\_\_\_

AMOUNT \_\_\_\_\_ COMPANY \_\_\_\_\_ STATUS \_\_\_\_\_

DEPENDENTS \_\_\_\_\_

LENGTH OF TIME AT ADDRESS \_\_\_\_\_

EMPLOYMENT INFORMATION			
NAME OF EMPLOYER		OCCUPATION	
LENGTH OF EMPLOYMENT		GROSS MONTHLY INCOME	
SPOUSE:			
NAME OF EMPLOYER		OCCUPATION	
LENGTH OF EMPLOYMENT		GROSS MONTHLY INCOME	

NET WORTH				
ASSETS	AMOUNT	LIABILITIES	AMOUNT	PAYMENTS
Real Estate		Mortgage		
Vehicle		LOC		
Vehicle		Loan		
Cash		Credit Card		
RRSP		Credit Card		
Mutual Funds		Other Credit Card		
RRSP				
<b>TOTAL ASSETS</b>		<b>TOTAL LIABILITIES</b>		
<b>NET WORTH</b>				

Date: \_\_\_\_\_ Signature(s): \_\_\_\_\_

[Figure 4.3] Example of a credit application. (Source: Professor Carla Van Horne, NAIT)

## Credit Granting

The lender will need to review the applicant's past financial behaviour to predict how they will handle credit in the future. This process ensures that the financial institution does not grant credit to clients who are unable to pay (AccountingTools, 2022). The goal for both the lender and the client is to continually improve their financial position so their financial goals can be achieved.

Financial institutions will have a strategic approach to how they handle their credit and lending departments. Some financial institutions will be more aggressive and take on higher-risk clients. This allows them to charge higher rates of interest to compensate them for the additional level of risk they are taking on. Other financial institutions will take a more measured and conservative approach to the extension of credit to clients. During times of economic uncertainty, it is not uncommon to see institutions tighten up their credit-granting processes as a way to navigate difficult times.

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## Reference

AccountingTools. (2022, May 14). [Credit granting procedure](https://www.accountingtools.com/articles/credit-granting-procedure). *AccountingTools, Inc.* <https://www.accountingtools.com/articles/credit-granting-procedure>

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5.

# CHAPTER 4 – CREDIT: INCOME VERIFICATION PART 2

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Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- why the income verification process is so important.
- the different sources that are acceptable for income verification.
- the income guidelines that could be used by a

financial institution.

Income verification is a critical step in the credit file process, and the lender needs to make sure it is completed accurately. A client's income indicates their ability to pay off their debt and affects how much of a debt load they can carry. If a lender has miscalculated a client's income, there can be serious problems with the credit file.

Imagine a situation in which a lender incorrectly calculates the client's income where the income is inflated. In this situation, a client could be approved for a debt load that will put them in the position of not being able to repay the debt. Alternatively, imagine the lender is halfway through the credit file, discovers their error, and corrects it. In this situation, the client no longer qualifies for the credit deal that was proposed. The lender will have to have an uncomfortable conversation with the client to let them know they do not qualify for the previously approved amount. Errors like this can hurt the client's relationship with the lender and the financial institution.

In another example, envision a situation in which the lender incorrectly calculates the client's income as being less than it actually is. In this situation, the client's credit request would

be unnecessarily declined. This missed opportunity is a loss of business for the financial institution and the lender. It is important that the lender verify and calculate the client's income correctly to show that the client can support the new debt, per the application, and confirm **CAPACITY**.

Each bank/financial institution has its own policies for income verification. It is important that a lender follow the guidelines of the financial institution where they are employed. The income verification guidelines described in this chapter are for the purposes of this course.

The lending products and services that a financial institution offers can have different income verification requirements. For example, a mortgage could have different requirements than overdraft protection placed on an account. Lenders need to have a strong understanding of the requirements necessary for each credit file. This will help ensure the quality of the credit file and demonstrate efficiency from a client's perspective.

## Sources of Income Verification

### Pay Stubs

The lender must ensure that the paystub is current. Usually, two to three pay stubs are required to show that the income is consistent. The paystubs should be clear; make sure the

employer is identifiable. The employee information should be consistent with the client in the credit file. Click the following link to see an [example of Canadian paystub](#).

## Salary Letter

Clients may be required to provide a salary letter. The letter will help determine if the individual is on probation. It should be on company letterhead. The lender should perform their due diligence by calling the person who wrote the letter to confirm that the letter is legitimate. The lender should document this on the letter by writing the date and time they spoke with the writer. Click the following link to see an [example of a salary letter](#).

## Notice of Assessments

Notice of Assessments (NOAs) are another source of income verification that a lender may need to request from their client. Different financial institutions have various policies around using NOAs as a source of income verification. Lenders are most concerned with line 150 for income verification information.

Clients can obtain a digital copy of their NOAs by accessing “My Account” with The Canada Revenue Agency (CRA).

Alternatively, clients may have a paper copy that they receive each year after filing their income taxes.

Line	Description	Amount
100	Total Income	10,100.00
101	Charitable Donations	500.00
102	Total Income	9,600.00
130	Total Taxable Income	9,600.00
131	Total Taxable Income	9,600.00
132	Total Taxable Income	9,600.00
133	Total Taxable Income	9,600.00
134	Total Taxable Income	9,600.00
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300	Total Taxable Income	9,600.00

Source: Advantage Wealth, 2025

## T4 Statement of Remuneration Paid (Slip)

Some financial institutions will accept a client’s T4 as an income verification source. Typically, a T4 statement is accepted as a verification source when a current NOA is not available. A lender would be concerned with line 14; they would use the information found there to verify a client’s

income for that year.

Source: Avanti, 2025

## Income Guidelines

As mentioned previously, financial institutions can have varying approaches for determining client income. Banks reserve the right to have their own policies regarding income verification. A lender is required to exercise due diligence to verify all sources of income to ensure the integrity of the credit file.

For the purpose of this course, we will follow the following guidelines. Make note of certain requirements for **CAPACITY**.

## Overtime/Commission Income

Usually, a lender cannot make this part of the income calculation as it is not considered to be guaranteed income. If the lender needs the additional income to bring capacity (GDS and TDS ratios) into line, the lender will need to obtain two years of the client's NOA to show a history of this income.

## Part-Time Employment

The lender will need to determine the minimum guaranteed hours per week. A salary letter is the best source of confirmation for this income. For **CAPACITY** considerations, part-time employment should be included in income. However, use the current wages, not the historical wages.

## Full-Time Employment

The lender will require the client to produce current pay stubs. Alternatively, if their pay is received via direct deposit, amounts can be taken, and a gross-up calculation can be used at the bank's discretion.

## Spousal/Child Support

The legal agreement needs to be obtained and a copy retained for the lender's file.

## Pension Income

The verification source could be an NOA or a T5. Some lenders may verify via direct deposit; amounts can be taken, and a gross-up calculation can be used at the bank's discretion.

## Rental Income

Rental income can be included in the calculation of the debt service ratios and form part of the client's total gross annual income. To verify rental income as a source, the client needs to produce rental agreements along with bank statements confirming consistent collection of rent.

## Review of Income Verification

**[Table 4.1] Income sources and how to verify them. (Source: Professor Carla Van Horne, NAIT)**

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<b>Full-Time Employment</b>	Pay stubs, direct deposits (bank dependent), T4s, or a salary letter are all acceptable.
<b>Overtime/Commission</b>	NOAs are needed to show a history of the income.
<b>Part-Time Employment</b>	The bank will need to determine the minimum guaranteed hours per week. These hours are used in the calculation of monthly income. A salary letter is the best source of confirmation of this income.
<b>Spousal/Child Support</b>	The legal divorce agreement must be obtained, and a copy must be retained for the lender's file.
<b>Pension Income</b>	NOAs, T5s, or direct deposit amounts can be taken, and a gross-up calculation can be used (at the bank's discretion.)
<b>Self Employed</b>	The last two years' NOAs can be used, taking the average of the two years.
<b>Maternity/Paternity Leave</b>	An employment letter is required to verify the full amount of income. The letter should indicate the timeframe of the leave and when the client is to return to the position in its full capacity.

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## Calculating Income

Full Time	Part Time	Fluctuating Income/Self Employed
Bi-weekly income = $(\text{gross amount} * 26) / 12$  Example: client receives \$2293.12 every two weeks $(2293.12 * 26) / 12 =$ \$4968.43/month	$(\text{Hourly rate} * \text{hours}$ $\text{guaranteed per}$ $\text{week} * \text{payment}$ $\text{frequency}) / 12$ Example: client is paid \$15/hour and works 25 hours per week and paid weekly $[(15 * 25) * 52] / 12 =$ \$1625.00/month	Average of Line 150 from last two years NOAs: Example: Clients 2021 NOA line 150 = \$45000. Clients 2020 NOA line 150 = \$49,000  $(45000 + 49000) / 2 =$ 47000 annually OR \$3916.67/month
Semi-monthly = $(\text{gross amount} * 24) / 12$ Example: client receives \$1193.12 every 15 <sup>th</sup> and 30 <sup>th</sup> $(2293.12 * 25) / 12 =$ \$4586.24/month		

**[Table 4.2] Examples of how to calculate income.**

**(Source: Professor Carla Van Horne, NAIT)**

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# CHAPTER 5 – REAL ESTATE LENDING: HOW IS IT DIFFERENT?

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Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- why clients seek out a mortgage or may want to access the equity in their home.
- why clients may want to refinance and what they should examine prior to refinancing.
- the different types of mortgages available.

- how mortgage rates and mortgage-interest rates are structured.
- important terms and definitions relating to mortgages.
- how to complete a real-estate-secured application.
- how a builder mortgage is different.

## Why Clients Seek Out a Mortgage Lender



There are several reasons why clients apply for a mortgage  
:

- to purchase a new or existing residential property;
- to build a residence or other property;
- to renew a mortgage term;
- to refinance a mortgage;
- to obtain interim (bridge) financing;
- to transfer an existing mortgage to a new lender;
- to change the people on a title;
- to remove a lien against a property; or
- to free up additional funds.

When individuals have accumulated equity in their home, they can use it to address financial needs that would otherwise be more costly to finance. Clients will use these funds for a variety of wants and needs, including:

- to purchase large ticket items;
- to renovate their home or to build an addition to their home;
- to fund their children's education;
- to take a long-awaited vacation;
- to use the funds for investment purposes;
- to purchase a rental property;

- to purchase a business;
- to establish a business operating line of credit (with the property as collateral); and
- to fund retirement.

All of following can be used to obtain access to the equity in a home:

- a home equity line of credit (HELOC);
- equity taken out of a mortgage;
- a second mortgage; and
- a reverse mortgage.

Mortgage refinancing occurs when the terms and conditions of an existing mortgage are replaced with new terms and conditions before a mortgage is due for renewal.

Reasons why someone would consider refinancing are as follows:

- to consolidate debt;
- to extend an existing mortgage amortization for lower monthly payments;
- to rewrite the mortgage to take advantage of lower-interest rates; and
- to pull out capital for a specific purpose by increasing the principal of the mortgage.



important for a mortgage lender to have a good understanding of the different types of mortgages so they can determine which type will best suit the client.

## Conventional Mortgage

If a client has 20% of the purchase price of the property to use for a down payment, a traditional mortgage is acceptable. This means the bank provides the remaining 80% in the form of a conventional mortgage. For the lender, this is considered favourable as the risk is reduced by the client having more equity in the home. For example,

- Suzanne has saved \$90,000 for a down payment.
- The home is worth \$450,000 on the real estate market.

Her lender calculates the following mortgage amount:

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Appraised value of home: \$450,000

Less 20% down payment: \$90,000

**Total mortgage amount** \$360,000

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## High-Ratio Mortgage

A high-ratio mortgage occurs when the mortgage amount

exceeds 80% of the value of the property up to the maximum of 95% of the value of the property.

The *Bank Act* and the *Trust and Loan Companies Act* require high-ratio mortgages to be insured against default

(Office of the Superintendent of Financial Institutions of Canada, 2020). The lender is insured against the risk, and the client pays the premiums. The client can choose to pay the premiums up front, or the premiums can be added to the mortgage principal. In Canada, there are three acceptable insurers of this type of insurance: 1) Canada Mortgage and Housing Corporation (CMHC), 2) Genworth Financial, and 3) Canada Guaranty Mortgage Insurance. The insurance premium can be transferred from one financial institution to another without added cost to the client if the mortgage principal amount increases. In a refinance, a new premium is charged on the top-up amount only.

<b>Loan-to-Value</b>	<b>Premium on Total Loan</b>	<b>Premium on Increase to Loan Amount for Portability</b>
<b>Up to and including 65%</b>	0.60%	0.60%
<b>65.01% to 75%</b>	1.70%	5.90%
<b>75.01% to 80%</b>	2.40%	6.05%
<b>80.01% to 85%</b>	2.80%	6.20%
<b>85.01% to 90%</b>	3.10%	6.25%
<b>90.01% to 95%</b>	4.00%	6.30%
<b>90.01% to 95% with non-traditional down payment</b>	4.50%	6.60%

**[Table 6.1] CMHC mortgage loan insurance information and premium rates. (Source: CMHC, 2025a)**

It is important to note that for certain specialty properties, the mortgage is required to be insured despite the loan to value being less than 80%, and this can vary by financial institution. For example, some financial institutions write mortgages on mobile homes, which require CMHC insurance regardless of the loan to value. For example,

- Roger and Pat have found their first home to purchase, and the asking price is \$275,000.
- The couple has \$13,750 in a combination of savings and RRSPs.

- They would like to include the CMHC premium into their mortgage as they do not have additional funds set aside for this cost.

Their lender calculates the following mortgage amount:

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Appraised value of home	\$275,000
Less required 5% down payment	-\$13,750
Potential maximum for a high-ratio mortgage, based on appraised value (maximum 95% LTV)	\$261,250
<b>Calculation of the CMHC premium:</b>	
CMHC premium at 4% ( $261,250 \times 0.04$ )	\$10,450
<b>ADD</b> premium to high-ratio mortgage amount.	\$271,700
<b>Total mortgage amount, including CMHC premium</b>	<b>\$271,700</b>

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Note that mortgage payments can now be calculated for Roger and Pat using the mortgage balance of \$271,700.

**[Table 6.2] Note regarding income verification for CMHC applications. (CMHC, 2018b)**

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The approach used will depend on the nature of the application for mortgage-loan insurance and the information available. For instance, when the property is the subject of the mortgage-loan insurance application, the following will apply:

- Up to 50% of gross rental income can form part of the borrower's gross annual income, and taxes and heat can be excluded in the calculation of debt service ratios.
  - For a two-unit owner-occupied property, CMHC will consider up to 100% of gross rental income from the secondary suite.
  - For investment (rental) properties that are not the subject of the mortgage-loan insurance application, net rental income can form part of the borrower's gross annual income.
- 

## Refinancing

Some lenders offer their customers refinancing options. This provides homeowners with the option to access the equity they have built up over time. Refinancing may involve changing the terms of the original mortgage agreement, and the refinanced portion may have a different interest rate than the original mortgage. There may be associated penalties, and these can vary from one financial institution to another.

## Home Equity Lines of Credit



A home equity line of credit (HELOC) works much like a regular line of credit. A client can borrow money whenever they want (up to the credit limit), pay it back, and borrow again. A HELOC allows clients to make interest-only payments, which means that clients could never actually pay the principle. Lenders should recommend that clients pay more than the monthly interest payment to ensure their balance (debt) is being reduced.

The [Office of the Superintendent of Financial Institutions \(OSFI\)](#) is an organization that regulates lenders and has set guidelines that address the maximum amount for

HELOCs. *Lenders may have a maximum of 80% loan-to-value (LTV) for a HELOC; however, the revolving portion cannot exceed 65%* (Office of the Superintendent of Financial Institutions of Canada, 2020).

**Example 1.0 – Client is applying for a HELOC and has an existing mortgage of \$200,000:**

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<b>Current Market Value of Home:</b>	\$500,000
Max. LTV on HELOC 80%:	\$400,000
Subtract existing mortgage:	-\$200,000
Amount of new HELOC:	\$200,000

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**Example 2.0 – Client is applying for a HELOC with no existing mortgage:**

<b>Current Market Value of Home:</b>	\$500,000
<b>Max. LTV on HELOC 80%:</b>	\$400,000
<b>No existing mortgage:</b>	0
<b>Amount of HELOC (revolving portion) 65%:</b>	\$325,000
<b>Amount of HELOC (fixed portion):</b>	\$75,000

---

For a revolving home equity lines of credit the lender calculates the minimum payment as interest only. As an example, if a client has a line of credit balance of \$50,000 and the interest rate is 5%, the payment is calculated as:

Step 1:  $(0.05 * \$50,000) = \$2500$

Step 2:  $\$2,500/365 = \$6.85$

Step 3:  $\$6.85 * 30 = \$205.48$  minimum payment due

The fixed portion of the home equity lines of credit is principal + interest, and is calculated the same as a regular mortgage.

***Stress test rules (see below) apply for HELOC qualification purposes.***

## Stress Testing for Mortgages



The Canadian Government decided that the housing market needed to slow down in 2017. New regulations were put in place in January of 2018 that apply to anyone applying for a mortgage. The stress test is not an added cost to the borrower; it is another method to determine if a client can afford their mortgage payments if interest rates increase in the future. Since the introduction of the stress test, the government has continued to modify the requirements. Lenders need to be aware of these changes and adjust accordingly. As of June 1, 2021, the rules changed to include the following (Financial Consumer Agency of Canada, 2021):

The lender will use the HIGHER of:

- the rate of 5.25% OR the client's negotiated rate plus 2%.

If a client already owns their home, they will be subject to the stress test under the following conditions:

- the clients are refinancing their existing mortgage;
- the clients are transferring their mortgage to a new lender; and
- the clients are taking out a home equity line of credit.

## **Mortgage Reform in Canada: 2024 Update**

### **New Measures Introduced in 2024**

On August 1, 2024, the federal government implemented a policy allowing 30-year insured mortgage amortizations for first-time homebuyers purchasing new builds. This change lowers monthly payments and increases accessibility to the housing market. (Department of Finance Canada, 2024)

Building on this measure, the government of Canada announced additional reforms to take effect on December 15, 2024, including:

- Increasing the insured mortgage price cap from \$1 million to \$1.5 million, acknowledging rising home prices. This adjustment—unchanged since 2012—enables more Canadians to qualify for mortgage insurance with a down payment under 20%.
- Expanding 30-year amortization eligibility to:
  - All first-time homebuyers, not just those purchasing new builds.
  - All buyers of new construction homes, regardless of whether it's their first purchase.

These changes are also designed to stimulate new home construction, including condos, to help address Canada's ongoing housing supply shortage. (Department of Finance Canada, 2024)

## **Strengthened Canadian Mortgage Charter**

The updated mortgage charter, introduced in Budget 2024, includes provisions that allow insured mortgage holders to switch lenders at renewal without undergoing a new mortgage stress test. This promotes lender competition and helps consumers secure better rates and terms at renewal. (Department of Finance Canada, 2024)

## Structure of a Mortgage

### Open Mortgage

An open mortgage allows the client to pay off their mortgage without the risk of penalty. Terms for an open mortgage can range from six months to five years. This type of mortgage is beneficial for a client who wants flexibility as they are expecting funds to pay off the mortgage. The rate of interest can be fixed or variable.

### Closed Mortgage

A closed mortgage indicates that the client cannot exceed the agreed-upon repayment terms of the mortgage without a penalty being applied. The rate of interest can be fixed or variable.

## Mortgage Interest Rate Structure

### **Fixed-Rate Mortgage**

A fixed-rate mortgage has an interest rate that is fixed, and it will not change over the length of the term chosen. The benefit for the client is that they will have consistent mortgage payments for the length of the term. They will not need to be concerned that their payments will change. For example, a

5-year term mortgage has a rate of 4.75%, and this rate remains the same for the entire 5-year period.

### **Variable-Rate Mortgage**

A variable-rate mortgage has an interest rate that is tied to the prime rate. Each financial institution will offer this type of mortgage in variation from prime to prime plus a certain percentage. This interest rate will change if the prime rate increases or decreases. Clients will find that when interest rates drop, more of their mortgage payment is being applied to the principal, while the opposite would be true if interest rates increase.

### **Split-Rate Mortgage**

A split-rate mortgage offers the client the ability to combine the features of a fixed-rate mortgage and a variable-rate mortgage into one product. A portion of the mortgage may have a fixed rate, while another portion has a variable rate. This option allows the client to take advantage of rate changes without exposing their entire mortgage principal to an interest rate risk.

## Mortgage Terms and Definitions



**Assumable Mortgage:** An assumable mortgage allows purchasers to take over (assume) an existing mortgage, though there is a requirement that the purchaser also needs to qualify for the mortgage. This would be beneficial to the purchaser if the existing mortgage has an interest rate that is lower than the current rates being offered.

**Cash Back:** This is an option that can be offered to a client that provides “cash” to them upon the funding of the mortgage. Clients often will use these funds for furniture, renovations, landscaping, or to assist in paying down other debts. This is not always the most favourable option, as the

interest rate in a cash-back mortgage is higher than regular mortgage rates. Clients will pay more in interest costs over the term of their mortgage.

**Construction/Builder Mortgage:** For a client who is building a home, most financial institutions will have the option of a construction/builder mortgage. This allows funds to be provided to the builder in stages. At each funding stage, the property is inspected to determine that the stage is complete, and then new funds can be advanced. During the building process, the client is responsible for paying interest on the amount that is outstanding. Once the house is complete, the mortgage converts to a standard mortgage, and principal and interest payments would be required.

**Homeowner's Insurance:** All financial institutions that issue mortgages require that the homeowner carry insurance on the property for not less than the replacement value in Canadian dollars. This ensures that the collateral/security is protected against damage or loss. The lender is required to obtain proof from the client that the property is adequately insured.

**Investment Mortgage:** An investment mortgage is an option for a client looking to purchase a rental property or to purchase a property to renovate and later sell for a higher amount. Each lending institution will have its own guidelines for this type of mortgage that lenders must adhere to.

**Mortgage for Newcomers:** These mortgage applications can often be quite difficult and involve a lengthy process to verify the identity and legitimacy of the information being provided. The lender needs to adhere to the financial institution's guidelines to determine creditworthiness and protect the institution against fraud.

**Portable Mortgage:** If a client has an existing mortgage and they are looking to purchase a new property, the client could choose to port their mortgage. In effect, this allows the client to move their existing mortgage with them to their new property. A portable mortgage option is typically reserved for fixed-term mortgages and does not include variable-rate mortgages. If a client needs additional funds to purchase, the lender can do a top-up for the required additional funds; this portion of the mortgage would be at the current interest rate. The client would see a blended rate on their mortgage statement, which contains the original mortgage rate and the new mortgage rate. If the existing mortgage is insured, and the mortgage is still considered to be a high ratio (loan to value exceeds 80%), then the client pays the insurance premium on the new funds and not the entire mortgage principal. This is because the original mortgage insurance premium has already been paid.

**Property Taxes:** Once a mortgage has been advanced, the client is responsible for paying the property taxes associated with the property. When a client requests a refinance, the

lender needs to verify that property taxes are paid and up to date. The concern is that if a client is not paying their property taxes, the city or county could put a lien on the property, which, in turn, puts the financial institution's security/collateral at risk.

**Reverse Mortgage:** A reverse mortgage allows the client to access the equity in their home either as a lump sum or as ongoing advances. This option is reserved for clients 55 years and older. Clients are not required to make payments but are required to pay property taxes and home insurance. The full amount that is owed comes due when the home is sold or both spouses have either moved or died. This option is beneficial for older clients as it gives them access to funds to assist with their retirement needs and allows them to stay in their homes longer.

## Other Required Documentation for Real Estate Lending

- the MLS listing
- purchase and/or sale agreement(s)
- homeowner's insurance statement
- property tax assessment

## Completing the Application



For all mortgage applications, the client would initially meet with the lender to apply for a mortgage and determine what amount they qualify for and what their different options are. In the first meeting, the lender completes the application in the same manner as a consumer loan. The lender needs to ensure they are careful and collect accurate information about the client's assets and liabilities as these are more closely scrutinized in a mortgage application. Wherever possible, a lender should complete their due diligence and verify all the assets a client states they have.

The initial meeting will bring about many questions and

answers. What is the purpose? When is the possession date? When are funds required? How are they obtaining the down payment?

Questions like these can lead the conversation to different solutions that fit the client's needs. For the purposes of this course, we will address common mortgage applications that a lender would encounter in financial institutions. A high-ratio mortgage purchase and an equity take out are two types of mortgages that a lender would commonly encounter. It is important to keep in mind that financial institutions can vary in the types of mortgages they grant and can approach the approval processes in different manners.

## High-Ratio Mortgage Application

A lender needs to clarify several different elements to determine how the mortgage application will be put together.

If the client has a current home, the lender would need to consider the following:

- Who is the holder of the mortgage?
- What are the monthly payments on the existing mortgage?
- What is the balance of the mortgage?
- Is the client planning to sell this home or planning to rent the property?

For the new property, the lender would need to consider the following:

- What is the address and legal description?
- What is the property type (e.g., single-family home, duplex, condo, etc.)?
- What is the purchase price?
- What is the amount and the source of the down payment?
- When is the closing date?
- What is the appraisal value of the new home?

Once the lender has this information, they can consider whether the client could potentially qualify for the mortgage.

**A client who is selling their property and buying another home would need to provide the lender with the following:**

- the MLS listing of their existing property and their sale agreement;
- the MLS listing for their new property and their purchase agreement;
- the income requirements: recent pay stubs *and* salary letter;
- the down payment verification; and
  - If the down payment is coming from the sale of property, then the sale agreement is sufficient.

- If a client is pulling funds from their savings, typically, 90 days of account history showing this amount is required.
- If a client is using funds from investments, current investment statements showing sufficient amounts for the down payment are required.
- If the down payment is a gift from family, a gift letter that is authenticated by the family's bank is required.
- If RRSPs are the source of funds, first-time homebuyers require RRSP investment statements.
- *home insurance and property tax confirmation would be handled by the solicitor upon completion of the deal.*

**A client who is buying their first home would need to provide the lender with the following:**

- the MLS listing for their new property and their purchase agreement;
- the income requirements: recent pay stubs *and* salary letter;
- down payment verification, which is the same as outlined above; and
- *home insurance and property tax confirmation would be handled by the solicitor upon completion of the deal.*

## Home Equity Line of Credit

## Application (Equity Take-Out)

**A client who is applying for a home equity line of credit to complete an equity take-out would need to provide the lender with the following:**

- their mortgage statement with the current balance shown. If the mortgage is at another financial institution, then a request would be made by the lender on behalf of the client to obtain that information from the other bank;
- the income requirements: recent pay stubs *and* salary letter;
- home insurance statement showing their policy is up to date; and
- property tax confirmation showing that property taxes are paid and up to date.

## Builder Mortgages



There comes a time when a client does not want to purchase an existing home. If they want to build the house of their dreams, a lender needs to be prepared to work with the client through this process, as it typically can be lengthy. On average, six months to a year can be expected from start to finish, but if complications arise, that timeframe can be much longer. The lender who sets the right expectations around the timing of a build will be appreciated by their clients.

What do you need from the client?

- construction plans/blueprints – for an appraisal of the

plans

- contract with the builder outlining all costs
- if the land is purchased, a copy of the deed and proof of sale
- if the clients are existing homeowners, they will need to determine their ability to carry two mortgages for the length of time the new home is built
- clients may need to rent out their existing home if they cannot carry two properties—you will need the rental agreement. Alternatively, a rental market evaluation may be needed.

The challenge that clients may not realize is how they can keep their existing home while waiting for their new home to be built. For some, this is very difficult as they must demonstrate that they can debt service both mortgages during the build. Sometimes clients will have to make difficult decisions like selling their home and renting—this would be factored into debt servicing, and clients would still need to show that they are within guidelines. Alternatively, if they sell, they move in with family while the building is happening. Another option is for the clients to rent their existing home and move in with family. The home-building process is time-consuming and not the easiest for clients, but the goal for them is their home once completed.

The land lot the clients are looking to build their home on is critical to the builder's mortgage process. Often land may not

be developed, nor have services set up for the land reducing the value of the land. Financial institutions often seek that the client has a minimum of 35%–50% invested in the land. Depending on the home builder, the clients may have options for purchasing the land. It is important to note that the options below are unavailable to all home builders; it will depend on how the home builder structures their business.

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**Option 1: Lot is included in the overall price**

This option makes the process more ideal and can be less costly to the buyer.

There is concern that the lot price is inflated in these deals.

**Option 2: Client must purchase the land separately**

This is known as a land loan.

Dependent on the financial institution clients are required to have minimum of 35%–50% down.

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Once we have received the construction plans or blueprints, you would need to have them appraised. The cost of the appraisal can be carried by the client, though, at times, the financial institution may have promotions to waive this cost. Appraisal fees can be between \$350–\$500. Getting the appraisal done and the lender receiving this information takes time. Once the value has been ascertained, the lender can determine if the client’s financing needs are sufficient and

begin the application. This is much similar to the process for an existing home mortgage.

**Construction/Builder Mortgages:** Funds are advanced in stages. At each stage, there is an inspection before new funds are advanced. The customer only pays interest on the outstanding balance. When construction is complete, the mortgage becomes a standard mortgage, and blended payments of interest and principal begin. There are two options for a builder mortgage that clients can work through. Again, this will depend on the home builder on what they allow.

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### **Completion Mortgage**

Builder fully funds the build and requires clients to have their mortgage fund when they move-in to the home. Similar to a regular mortgage application.

Advantage to the client: allows time to sell their existing home if they have one.

Disadvantage to the client: dependent on the builder whether this is the option.

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### **Progress Draw Mortgage**

When the build meets certain stages of progression the lender will fund in installments until the project is completed or close to completion.

More common practice that is seen is the progress draw mortgage. Let’s take a look at a progress draw:

Draw Stage	Required Building Completion	Construction Stage	% of Total Mortgage Amount Advanced
1st Draw (Optional)	15% complete	Excavation and foundation complete	15%
2nd Draw	40% complete	Roof is on, the building is weather protected (i.e. airtight, access secured)	25%
3rd Draw	65% complete	Plumbing and wiring is started, plaster/drywall is complete, furnace installed, exterior wall cladding complete, etc.	25%
4th Draw	85% complete	Kitchen cupboards installed, bathroom completed, doors have been hung, etc.	20%
5th Draw	100% complete	Ready for occupancy with seasonal and exterior work completed	15%

**[Table 6.3] Progress Draw. Source:**

**<https://www.ratehub.ca/construction-mortgage-loans,2022>**

If the client already owns the land being built, a first advance is available as equity take-out. If the land is not yet purchased, a first advance is available to assist the client with purchasing a vacant lot.

Before each draw is advanced, an inspector will go to the property to ensure the builder follows the NHW (New Home Warranty) policies and to ensure each stage is completed with accuracy before releasing funds.

The cost of the inspections falls on the client. Some banks deduct appraisal and progress inspection fees from each draw.

After the mortgage is approved and signed, the client will not be able to change their mortgage amount to accommodate any upgrades or changes made to the home.

A lender needs to be versatile in residential lending; there are a variety of requests that a lender could receive and each one different. The more experience a lender gets working through applications, the more experienced and successful they will be.

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## Media Attributions

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7.

# CHAPTER 6 – FRAUD AWARENESS

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## Learning Objectives

### LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- what the most common types of fraud in lending are.
- the meaning of Know Your Customer (KYC) and Know Your Transactions (KYT) and how they help detect and deter fraud.
- what acceptable forms of identification are.
- straw buyers, auto loan fraud, internal

- banking fraud, and mortgage fraud.
- how good decision-making skills are necessary to meet client needs while still maintaining business objectives.

## Fraud Prevention in Lending Transactions

Lenders have a responsibility to protect the financial institution at which they are employed. They also have a responsibility to their clients to ensure that fraud or other financial crimes are not being committed in their name and that the client does not become a victim of a fraud scheme. Lenders need to proceed with care and caution with each client interaction to ensure their credit file is legitimate.

## Understanding the Prevalence of Fraud

According to the 2021 Federal Trade Commission report, almost all financial fraud in the U.S. involved identity theft, which represented a 50% increase from the previous year.

Loan application fraud was one of the main complaints. Lenders need to know how to recognize and prevent fraud and, with experience, anticipate fraud happening. This chapter provides an overview of the techniques used by lenders and financial institutions to prevent fraud in lending transactions.



Source: (Statistics Canada, 2024)

## Know Your Customer/Client

The know your customer/client (KYC) rule plays a significant role in all areas of banking because it is a way of detecting and deterring financial crimes. What is KYC? KYC is a mandatory process to identify and verify a client's identity when first meeting with them to discuss their credit request. KYC ensures that the client is real and that they are who they say they are. If the client is an already existing client, it is still necessary to verify their identity by taking two pieces of accepted ID and verifying those against the information on file that had been previously collected.

According to the Financial Consumer Agency of Canada, there are different combinations of acceptable identification (Financial Consumer Agency of Canada, 2022).

### Option 1

Show two pieces of ID from List A:

**(Source: Financial Consumer Agency of Canada, 2022)**

---

### **List A**

Valid Canadian driver's licence that can be used as ID under provincial or territorial law

Canadian passport

Birth certificate issued in Canada

Social Insurance card issued by the Government of Canada

Old Age Security card issued by the Government of Canada

Certificate of Indian Status

Provincial or territorial health insurance card that can be used as ID under provincial or territorial law

- Contact your provincial or territorial Consumer Affairs office to confirm if your health insurance card is an acceptable piece of ID where you live

Certificate of Canadian Citizenship or Certification of Naturalization

Permanent Resident card or an Immigration, Refugees, and Citizenship Canada (IRCC) form IMM 1000, IMM 1442, or IMM 5292

- IRCC also issue form IMM 5688 as a Confirmation of Permanent Residence. Check with your bank or federal credit union to see if they will accept this form.

Document or card with your picture and signature on it issued by one of the following authorities or its successors:

- Insurance Corporation of British Columbia
- Alberta Registries
- Saskatchewan Government Insurance
- Department of Service Nova Scotia and Municipal Relations
- Department of Transportation and Infrastructure of the province of Prince Edward Island
- Service New Brunswick
- Service NL of the province of Newfoundland and Labrador
- Department of Transportation of Northwest Territories
- Department of Community Government and Transportation of Nunavut

## Option 2

A person can:

- show **one** piece of ID from List A above, **and**
- show **one** piece of ID from List B

(Source: Financial Consumer Agency of Canada, 2022)

---

**List B**

Employee ID card with your picture on it that has been issued by an employer well known in the community

Debit card or bank card issued by a member of Payments Canada with your name and signature on it

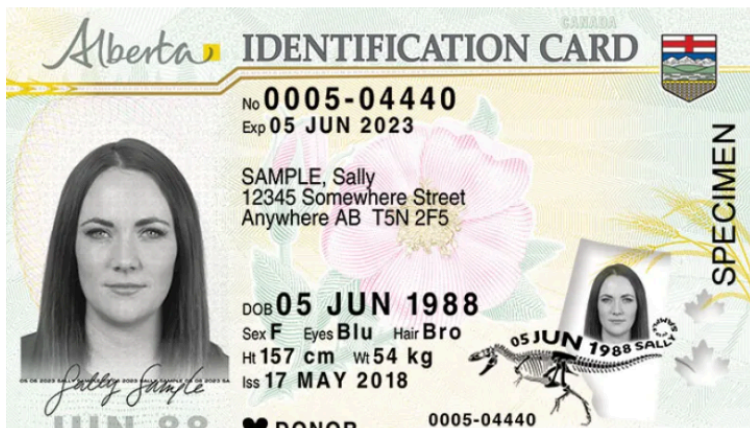
Credit card issued by a member of Payments Canada with your name and signature on it

Client card from the Canadian National Institute for the Blind with your picture and signature on it

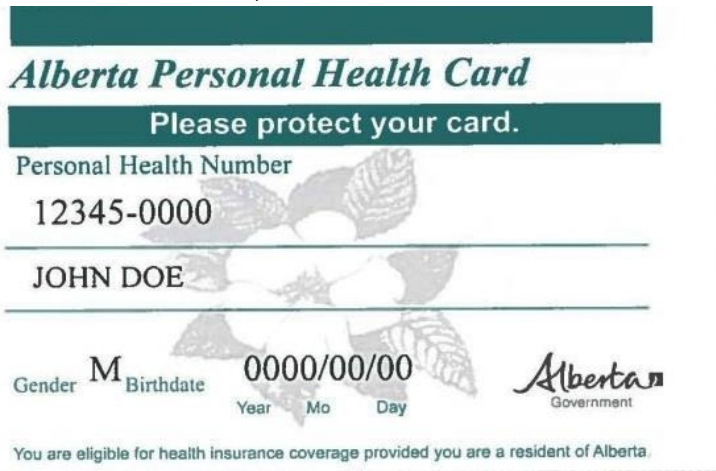
Foreign passport

---

## Example of Common IDs (Alberta)



[Figure 6.2] Example of Alberta identification card. (Source: Government of Alberta)



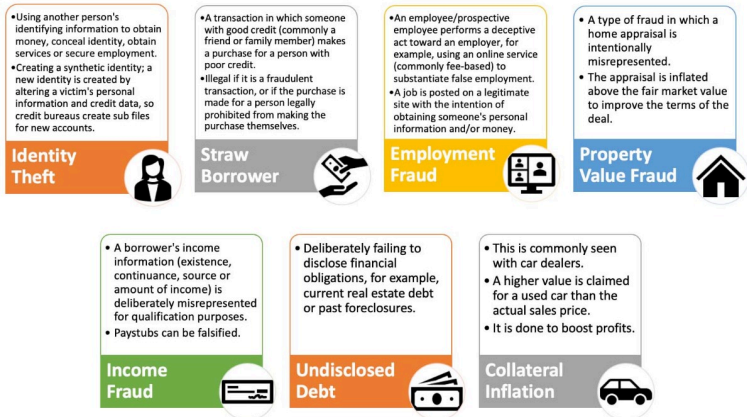
[Figure 6.3] Example of Alberta health card. (Source: Alberta Health Services)

While lenders need to be vigilant to ascertain their client’s identity, they must be careful not to falsely accuse someone, as repercussions can be severe. Read [this article](#) where a bank employee suspected clients of presenting fraudulent Indigenous status cards and called 911.

## Know Your Transaction

Know your transaction (KYT) is a commonly used term in the financial industry. It means to examine all financial transactions for fraudulent or suspicious activities, including money laundering (CipherTrace, 2022). In regard to lending,

the lender should always ask themselves, “Does this transaction make sense?” Product knowledge and a solid understanding of the financial institution’s processes is critical for the lender to grasp. It is vital to re-examine the purpose of the loan request and confirm that it appropriately aligns with what the client is asking for from the lender. Fraud prevention is a significant part of the lender’s role. If a lender misses seeing something suspicious or chooses to ignore something questionable just to get a credit deal done, this can lead to the lender being fired by their employer.



[Figure 6.4] Types of Fraud

## Different Types of Fraud

### Straw Buyer Fraud

A straw buyer is a person who buys something on behalf of another person to circumvent legal restrictions or enable fraud

(Lexico, 2022). Straw buyer mortgage fraud occurs when someone agrees to put their name on application on behalf of another person. The straw buyer typically receives a cash payment (Real Estate Council of Alberta, 2022). Click the following links to learn more about how the scam works and how to spot straw buyers.

- [Straw Buyer Mortgage Fraud](#)
- [How to Spot Straw Buyers in Real Estate Fraud Scenarios](#)

## Auto Loan Fraud

As with all financial transactions, auto loans are occasionally subject to fraud. This can take many different forms and involve a variety of different scams. Often, it will involve the use of stolen identification and the transactions will be completed online rather than in person.

Click the following link to a CBC News report to see how [the pandemic lead to spike in auto fraud cases](#).

## Internal Banking Fraud

Employees and former employees of financial institutions are known to participate in fraud schemes as well. In fact, fraud carried out by internal employees is a significant global

problem. These employees are in a unique position as they have a front seat to an institution’s internal controls and it is easy for them to exploit any weaknesses (NetGuardians, 2022).

Click the following link to a CTV news report to review [a recent example of bank loan fraud](#).

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## Mortgage Fraud

### Case Study – Inexperience Isn't a Defense

*By Chip Cumming, CFE*

*Originally published in Mortgage Compliance Magazine (June 5, 2014)*

Even though it was ten o'clock in the morning, it was still unusual to hear a knock at the front door. Sonya opened it slowly and was surprised to find two sharp dressed men on the porch.

*“Good morning, are you Sonya?”*

*“Yes, I am” she replied.*

*“We’re with the FBI, and we’d like you to come with us....”*

Such was the start of a 3-year nightmare for Sonya, in a twisted tale of mortgage fraud that involved over a dozen loans and millions of dollars in losses. Well, it actually started long before that.

Sonya was a processor hired directly by Charles, an experienced loan originator working for a “net branch” operation back in 2003. Although she had no experience, Charles was quickly able to teach her the basics of putting a loan package together, and she loved the fast pace of the new job.

Charles was a top producer, working exclusively with single-family investment properties, and some seemingly experienced rehabilitation specialists. Investors would purchase properties, fix them up, and then sell them to new first-time homebuyers. Charles would help the new families obtain the FHA mortgage and even arrange for gifts or creative down-payment scenarios to help them get into the new home for little or no money down...

You can see where this is headed. Unfortunately, Sonya didn't.

### **The Scheme**

Under the premise of “prepaying for repairs,” the seller of the property would advance certain funds to the borrower prior to closing. For convenience, Charles and the seller would document this as “gift funds” and coordinate with the

appraiser to obtain an inflated “as is” appraisal. After the closing, some additional funds were promised to the borrower so they could complete the repairs, and the seller would walk away with the profit. Charles earned a nice commission, and the repairs eventually got done so the appraiser was covered.

Things seemed to be going so well that Charles even helped the sellers out by participating in transactions as an equity partner (under the guise of an LLC) and would take a percentage of the profits after the deal closed.

Everyone was happy. Investor sellers were happy, new homebuyer borrowers were happy, Sonya was busy and earning nice bonuses and Charles was living a comfortable life. Maybe too comfortable.

*But there’s always a catch.*

## **The Catch**

One of the problems with fraud is that success breeds greed. The participants eventually want a bigger slice of the action or to build up the operation to generate more deals. The profits are too good, and the money spends too easy.

But there was one catch that Charles didn’t plan on—uncompleted repairs.

The city housing commission cited one of the property owners

for safety violations. The homeowner who had financed the property with Charles had turned it into a rental property, and the tenants had complained about the condition of the home. Upon inspection, the city decided that there were severe safety issues and subsequently condemned the property.

With no rental income, the mortgage payments stopped, and the loan went into foreclosure. When investigating the loan, it was quickly discovered that stated repairs were never completed, the appraisal was fraudulent, and the true value was a fraction of what everyone thought it was. But that was just the tip of a very large iceberg that was about to come crashing down.

The homeowner filed a complaint stating that the seller was supposed to complete and pay for the repairs but of course didn't. Loan files with similar problems and patterns became evident. Cross litigation followed, but as everyone looked around, nobody was there to pick up the pieces.

With the turn of the market, values had gone down, investors became hesitant, buyers became fearful, and mortgage offices shut down. At this point, even Sonya had been working at a health club for the past year and hadn't seen or talked to Charles in years.

## **The Charges**

The interview at the FBI office didn't go well for Sonya. She was asked about her time at the mortgage company, her processing duties, and about her experience. Sonya indicated that she hadn't had any formal training or experience in the mortgage industry but that she had enjoyed her time working with Charles. She confirmed that she had worked on many loan files for him and that he seemed like an experienced investor and finance expert. As a processor, her signature was on many of the documents.

Sonya was then charged with multiple felony counts, including mail fraud, wire fraud, and conspiracy to commit fraud. She was now looking at several years in federal prison.

As a certified fraud examiner, I became involved with her defense team to try to find out what really happened and what Sonya knew—or didn't know. As I poured over stacks of loan files, her inexperience became obvious, and I could see that Charles was running the show. He had trained her in a specific way, and she knew nothing different, and she certainly didn't question him on the operation.

But unfortunately for Sonya, inexperience isn't a plausible defense. There were plenty of warning signs, and looking back, she knew something didn't feel right. But what could she have done?

What should have tipped her off to the scheme? How could

the lender have better protected itself? And was she really looking at hard prison time?

### **The “Red Flags”**

In analyzing the loan files, there were several warning signs that should have alerted Sonya that something was wrong. Loan processors are a gateway for lenders to detect and prevent fraud, and processors should be extra careful in documenting unusual circumstances and similar patterns involving the same parties in a transaction, and they should not be afraid to ask questions when things are not clear. Some of the red flags that Sonya could have questioned included the following:

- multiple deals with the same investor within a short period of time
- similarly structured Gift Letters on multiple transactions with the same parties
- agreements for advance repairs or payments to a buyer prior to closing
- any agreements outside of the closing
- the loan officer involved as a “silent partner” on transactions with payments prior to or after closing

While these are just a few of the identified patterns and individually may not constitute a fraudulent transaction or intent, these red flags are among the easiest to catch by a processor on the front lines early in the process.

The lender could also have identified certain red flags in its process that may have alerted them to a problem. Internal procedures should include the following:

- identifying similar parties to multiple transactions
- Gift Letter verification procedures
- review of borrower verifications
- internal valuation reviews (*acknowledging that appraisal requirements and procedures have changed in recent years*)
- on-site branch audits, vendor due diligence and agreements, and compliance checks and certifications

### **The Fallout**

After a lengthy investigation and review of the files, I was able to prepare a report which demonstrated that Sonya was an unintended co-conspirator, and she was offered a deal to cooperate and testify against others involved in the fraud. While this spared her jail time, it didn't come without a cost. Probation, fines, the elimination of certain types of future employment, and public embarrassment—not to mention attorney fees, costs, time, and whole boatload of headaches and stress. Charles is now serving time in federal prison, and several others were charged in the case.

But that's not the only fallout. Additional damage was done to the scores of buyers and families caught up in a system that

allowed them to be led down a dangerous path. While there are certainly procedures and systems in place to protect buyers, lenders, and even people like Sonya, the systems are only as good as the people who run them. The integrity of the team members, practical and comprehensive training, attention to detail, and the willingness to ask simple questions if something doesn't seem quite right—those are the best protections against fraud.

That's something Sonya wished she had learned many years ago.

*Author Note: The names and identifying features of this case study have been modified for privacy reasons.*

Chip Cummings is the CEO of Northwind International Corp. and a certified fraud examiner with over 27 years of real estate lending and compliance experience. He is a best-selling author of nine books and a frequent speaker around the country. Chip can be reached at (866) 977-7900, via email at [Info@NorthwindInternational.com](mailto:Info@NorthwindInternational.com), or through [www.MortgageFraudConsultants.com](http://www.MortgageFraudConsultants.com).

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## Balancing Client Needs Against Business Objectives

Lenders are absolutely required to protect the financial institution for which they work, but they need to be able to balance this against the needs of their clients and what they need to do to help their clients achieve their goals. Read the following article, “[Principles of Good Lending Every Banks Follows – Loans](#)“ by Gaurav Arkani. In this article, he looks at seven general principles of good lending:

1. Safety
2. Liquidity
3. Purpose
4. Profitability
5. Security
6. Spread
7. National interest, suitability, etc.

These are principles that all lenders should follow when appraising a proposal.

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# CHAPTER 7 - BANKRUPTCY

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Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- default and the signs that can indicate a client is not financially stable.
- the different parties involved in the bankruptcy process.
- the criteria an individual must meet to declare bankruptcy.
- what assets are non-exempt from bankruptcy

- and what debts still must be paid.
- the advantages and disadvantages of declaring bankruptcy.
- how to calculate surplus income.
- the alternative options to bankruptcy and the advantages and disadvantages of each.

## Risk of Default

While lenders do their best to ensure that each credit application is of sound quality, there are times when a client, for one reason or another, does not fulfill their obligations to the lender and defaults

on their loan. There is a process that exists for this type of client, and understanding this process will help a lender remain cognizant of the fact that there is always the potential for a deal to go wrong. In addition, the lender should be aware of what options are available for the client in this type of situation, and the lender should help the client develop a plan to address it.

There are signs that can indicate an individual is experiencing challenges with their financial situation (see the list below). If

these challenges are caught early, the lender can provide credit counselling to the client and help them avoid bankruptcy.

**[Table 7.1] Credit warning signs. (Source: Professor Carla Van Horne, NAIT).**

---

Client is using credit to create income.

Client is making only their minimum payments.

Client indulges in impulse buying (look at their bank statements for patterns).

Client has no savings or has no money before payday.

Client requests loan consolidations often.

Client is not sure of their monthly expenses.

Client has employment problems.

Client has a substance abuse problem.

Client has a problem with compulsive spending.

Client has an issue with gambling.

Client is facing medical problems.

Client is financing their education.

Client is dealing with a breakdown in their marriage.

Client is involved in lawsuits.

Client has a history of bad investments.

Client fails to pay income tax on self-employed earnings.

---

Credit counselling is an option for a client who still has the ability to pay but is overwhelmed by high interest rates. If the lender is not equipped to provide credit counselling, they can recommend another financial advisor or other credit counselling organizations to the client.

# Bankruptcy



An individual should only consider bankruptcy after they have tried every debt management option available to them. If these options do not work, then seeking out a licensed insolvency trustee (LIT) would be the next step. An LIT will advise the individual about the effects of filing for bankruptcy and explain all the possible options. A lender should have a good understanding of bankruptcy and be able to support their client when and if the time to file bankruptcy arrives.

To understand how bankruptcy works, it is important to learn about the different parties that are involved in the bankruptcy

process. Two important terms that will be used throughout this section are

debtor

and

bankrupt

.

## Representatives of the *Bankruptcy and Insolvency Act* (Plus Other Roles Involved in the Bankruptcy Process)

### **Office of the Superintendent of Bankruptcy Canada**

The Office of the Superintendent of Bankruptcy Canada (OSB) is responsible for overseeing all matters for which the *Bankruptcy and Insolvency Act* (BIA) applies as well as certain issues relating to the *Companies' Creditors Arrangement Act* (CCAA). The OSB licenses and regulates the insolvency profession. It also oversees estates in bankruptcy, the reorganizations of commercial organizations, consumer proposals, and receiverships (Office of the Superintendent of Bankruptcy Canada, 2018).

### **Official Receiver**

An official receiver is a federal government employee, specifically in the OSB. They are appointed by Governor in

Council. This role has many responsibilities, including accepting all documents that are filed in proposals and bankruptcies. The official receiver also examines bankrupts under oath and will chair the meetings of the creditors (Office of the Superintendent of Bankruptcy Canada, 2015).

### **Registrar in Bankruptcy**

The registrar in bankruptcy is a court official who has a judicial role in bankruptcy court on discharge hearings, bankruptcy and insolvency-related motions, and examinations of the debtors, creditors, and any other parties involved in insolvency matters (Rumanek & Company Ltd, 2022).

### **Licensed Insolvency Trustee (LIT)**



An LIT is a federally regulated professional who provides advice and services to individuals and businesses in Canada who are experiencing debt problems (Office of the Superintendent of Bankruptcy Canada, 2016). The trustee notifies creditors of bankruptcy assignments and will collect, review, and approve submitted claims. Throughout the bankruptcy period, the trustee will collect payments, ensuring that the debtor fulfills their requirements. The trustee also distributes funds to the creditors. An LIT has a

fiduciary duty

and is obligated by the BIA to act honestly and in good faith; they are bound to the established code of ethics for LITs.

### **Inspector**

An inspector is appointed by the creditors and represents the interests of the creditors during the administration of the bankrupt's estate. An inspector also has a fiduciary duty and performs their duties impartially and in the interest of the creditors. An inspector will give direction to the LIT regarding any required actions that need to be taken in the handling of the bankrupt's estate. The inspector also oversees the LIT's administration to ensure that the LIT acts in accordance with their direction.

### **Creditors**

There are three types of creditors: secured, unsecured, and

preferred. Creditors are to participate in and vote at the meetings of the creditors. They have a duty to appoint an inspector and can also serve as an inspector. A creditor informs the LIT of any irregularities that are seen on the part of the debtor of the bankrupt.

## **Debtor**

The debtor owes money and has been assigned or petitioned into bankruptcy, or they filed a proposal.

## How Does an Individual Qualify for Bankruptcy?

To qualify for bankruptcy, an individual must meet the following criteria (Bankruptcy Canada, 2022):

- owes a debt of at least \$1000 (minimum);
- the value of the debts exceeds the value of assets; and
- they are unable to pay debts as they come due.

Once the LIT has filed bankruptcy, creditors are barred from contacting the individual. For the debtor, this provides relief from the hassle of dealing with collection calls, legal actions, and garnishment of wages, along with making payments on most debts.

The LIT will prepare and file any outstanding tax returns up

until the date of bankruptcy. Any outstanding balances and/or penalties will be included in the bankruptcy filing. An individual's income tax refunds are considered assets to the bankrupt's estate.

The bankrupt is obligated to fulfill all their requirements to eventually be discharged from bankruptcy.



[Figure 7.1] Requirements the bankrupt must satisfy to be discharged from bank.

Duties of the Bankrupt:



*One or more interactive elements has been excluded from this version of the text. You can view them online here:*

<https://pressbooks.openeducationalberta.ca/credit/?p=109#oembed-1>

**[Video 7.1] Duties of the bankrupt. (Source: Hoyes and Michalos/YouTube)**

What the Bankrupt Can Keep and  
What They are Required to Pay



[Figure 7.2] Exempt assets. \*The proceeds from the payment are separate from the bankrupt's other funds.



[Figure 7.3] Non-dischargeable debt.

The bankrupts will have an R9 on their credit rating, and that will remain on their credit report for six years after they are discharged. While it will be difficult for the bankrupt to obtain credit in the future, it does not necessarily disqualify them.

## Automatic Discharge

If the bankrupt meets all their requirements and obligations and there is no opposition to an automatic discharge, they will be granted one based on the following:

**[Table 7.2] Time periods of automatic discharge. (Source: Bankruptcy Canada, 2022)**

<b>Automatic Discharge Period</b>	<b>No Surplus Income</b>	<b>Surplus Income</b>
First Time Bankrupt	9 months	21 months
Second Time Bankrupt	24 months	36 months

## Advantages and Disadvantages of Bankruptcy

### **What are the advantages of bankruptcy?**

It provides a bankrupt with legal protection from creditors. They will not face wage garnishments or judgements. It also wipes out the majority of an bankrupt's unsecured debts (e.g., loans, credit card debt, etc.) With a first bankruptcy, it is common for an individual to be debt free within 9 to 12 months. The cost of filing for bankruptcy is rather low, notably when compared to the cost an individual would face if they had to continue paying their debts (Bankruptcy Canada, 2022).

### **What are the disadvantages of bankruptcy?**

An bankrupt's credit score will be lower for a minimum of six years from the time the bankruptcy is complete. Some assets

may have to be surrendered. A portion of the bankrupt’s income (above a certain level) may be allocated toward their bankruptcy. The trustee must be provided with detailed information on the bankrupt’s income and expense information. An income tax refund, if received, is part of the bankruptcy. The refund will be forfeited to the trustee for the year of the bankruptcy (Bankruptcy Canada, 2022).

## Determining Calculations for Surplus Income in Bankruptcy

The bankrupt is required to make as much restitution as possible for their failure to pay their debts. The OSB has established the Superintendent’s Standards, which are derived from the low-income cutoffs released by Statistics Canada (Office of the Superintendent of Bankruptcy Canada, 2020).

released by Statistics Canada (Office of the Superintendent of Bankruptcy Canada, 2020).

APPENDIX A

ANNEXE A

SUPERINTENDENT’S STANDARDS

NORMES DU SURINTENDANT

2022

Persons Personnes	S (\$) N (\$)	FAMILY UNIT'S AVAILABLE MONTHLY INCOME (\$) REVENU MENSUEL DISPONIBLE DE L'UNITÉ FAMILIALE (\$)																
		2555	2755	2955	3155	3355	3555	3755	3955	4205	4505	4805	5105	5405	5705	6005	6305	6605
1	2355	200	400	600	800	1000	1200	1400	1600	1850	2150	2450	2750	3050	3350	3650	3950	4250
2	2931	0	0	0	224	424	624	824	1024	1274	1574	1874	2174	2474	2774	3074	3374	3674
3	3604	0	0	0	0	0	0	0	351	601	901	1201	1501	1801	2101	2401	2701	3001
4	4375	0	0	0	0	0	0	0	0	0	0	430	730	1030	1330	1630	1930	2230
5	4962	0	0	0	0	0	0	0	0	0	0	0	0	443	743	1043	1343	1643
6	5597	0	0	0	0	0	0	0	0	0	0	0	0	0	0	408	708	1008
7+	6231	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	374

[Table 7.3] Appendix A/Superintendent’s Standards – 2022. (Source: Office of the Superintendent of

## Bankruptcy Canada, 2020)

### Calculation Examples

Monthly net pay=	3,700
Less	
Items that survive bankruptcy: (Medical, dental, alimony, child support, student loans, court fines)	200(student loan)
Total	3500
Less Family Unit Allowance(see previous chart)	2355
Total	1145
Divide by 2	572.5 x 21 months= \$12,022.50
Because the payment exceeds \$200 this individual pays the higher amount.	If the total was less than \$200 the individual would pay the min required \$200

**[Table 7.4] Example of surplus income calculations for an individual. (Source: Professor Carla Van Horne, NAIT)**

Monthly net pay=	\$6250
Less	
Items that survive bankruptcy: (Medical, dental, alimony, child support, student loans, court fines)	700(child support)
Total	5550
Less Family Unit Allowance(see previous chart)	4375
Total	1175
Divide by 2	587.50 x 21 months= \$12,337.50
Because the payment exceeds \$200 this individual pays the higher amount.	If the total was less than \$200 the individual would pay the min required \$200

**[Table 7.5] Example of surplus income calculations for a family of four. (Source: Professor Carla Van Horne, NAIT)**

**Note:** The minimum payment required is \$200/month that a bankrupt will need to pay. If there is surplus income, the bankrupt is required to pay the higher amount.

**[Video 7.2] Surplus income explained. (Source:**

## Innovation, Science and Economic Development Canada/YouTube)



*One or more interactive elements has been excluded from this version of the text. You can view them online here:*

<https://pressbooks.openeducationalberta.ca/credit/?p=109#oembed-2>

## Alternate Options to Bankruptcy

While bankruptcy can be an option for some individuals, it is important that a lender be knowledgeable about the other options that are available. In this course, we will focus on consumer proposals and orderly repayment of debts.

### Consumer Proposals

Consumer proposals are one alternative option to bankruptcy for a person experiencing challenges meeting their debt obligations.

A consumer proposal is administered under Part III, Division I of the *Bankruptcy and Insolvency Act* (Justice Laws Website, 2022). It is an agreement made on behalf of the debtor and

their creditors in which they settle the debts and create a schedule for repayment. Consumer proposals allow for lump sum payments to be applied; otherwise, the repayment term for the proposal is a maximum of five years.

In Alberta, for a debtor to be eligible for a consumer proposal, they must be incapable to make payments as they come due (for any reason), or they must stop making payments as they come due. They must owe their creditors less than \$250,000. It is 500,000 for married couples. The amount of their assets must be insufficient to satisfy their debts, and they are required to hire a licensed bankruptcy trustee to mediate with their creditors on their behalf (Debt.ca, 2022).

Creditors must be in a better position than they would be if a debtor filed for bankruptcy. Creditors must be in agreement (of at least 51%) to support a consumer proposal. The consumer proposal will result in an R7 rating on the individual's credit report and remain on the credit report for a maximum of five years.

**[Table 7.6] LIT's role in a consumer proposal. (Source: Consolidated Credit, 2022)**

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The LIT will report any adverse change to the creditors.

The LIT will assist the debtor in the preparation of the proposal.

The LIT will provide a report and recommendation for the creditors on whether or not to accept the proposal.

The LIT will collect amounts due from the debtor and pay dividends to creditors as per the proposal.

Once the proposal is complete, the LIT will issue a certificate of full performance to the debtor and then apply for the trustee's discharge.

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**[Table 7.7] Debtor's role in a consumer proposal. (Source: Office of the Superintendent of Bankruptcy Canada, 2015)**

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A complete list of all assets (property) and liabilities (debts) must be provided to the LIT.

If a meeting is requested by the creditors, the debtor must attend the first meeting.

The debtor should attend two counselling sessions.

The debtor must notify the LIT, in writing, if their address changes.

The debtor should aid the LIT in the administration of the proposal.

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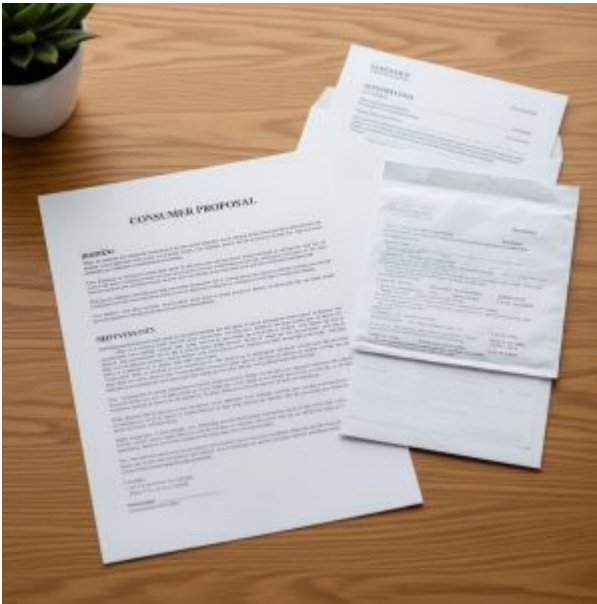
It is important to note that only a portion of the total debt owed by the debtor is repaid, and typically, there is a higher net percentage available to the creditors with a consumer proposal when compared to a bankruptcy.

Bankruptcy		Consumer Proposal	
Non-exempt assets and surplus income:		Proposed payment in a Consumer Proposal	
Surplus Income	\$8000	\$285 x 60 months	\$17100
RESP (Cash Value)	2000		
Boat (Auction Value)	<u>4000</u>		
Total	14000		
Less Trustee Fees	(8058)	Less Trustee Fees	(5059)
Net amount available to creditors: <b>\$5942</b>		Net amount available to creditors: <b>\$12041</b>	
Net percentage available to Creditors: 8%		Net percentage available to Creditors: 16%	

**[Table 7.8] Example of bankruptcy versus consumer proposal. (Source: Professor Carla Van Horne, NAIT)**

As shown above, creditors often end up in a better position than they would have been if a bankruptcy process were filed, and that is why consumer proposals generally get approved.

## Advantages and Disadvantages of a Consumer Proposal



### **What are the advantages of a consumer proposal?**

For the majority of Canadians, the costs and fees that come with a consumer proposal are significantly less than the costs that come with bankruptcy. Once a consumer proposal has been signed, debt collectors will stop bothering the debtor, and the debtor's physical assets will be protected. Once the

creditors (representing 51% of the debtor's debt) agree to a consumer proposal, they are obligated to work with the debtor (Debt.ca, 2022).

### **What are the disadvantages of a consumer proposal?**

While a consumer proposal is less expensive, it has the same negative impact on a debtor's credit that a bankruptcy does. It will remain on the a debtor's credit report for up to seven years. The proposal will not go into effect if it is denied by 51% of the debtor's creditors, and trustees are obligated to pay creditors as much as possible (Debt.ca, 2022).

## Orderly Payment of Debts



Orderly payment of debts (OPD) is a debt payment program that is an alternative to bankruptcy in Canada. It is offered under the *Bankruptcy and Insolvency Act of Canada* (Bankruptcy Canada, 2022). This program is only available in the following provinces in Canada: Alberta, Saskatchewan, Prince Edward Island, and Nova Scotia.

Who is eligible for an orderly payment of debt program?

- Someone who is able to afford their debts in full.
- Someone who cannot afford the existing interest rates they are paying.
- Someone who cannot qualify for a consolidation loan.

### **Filing Process for Orderly Payment of Debt**

**[Table 7.9] Steps for filing an ORD. (Bankruptcy Canada, 2014)**

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**Steps    Actions**

**Step 1**      **Contact a local administrator.** The debtor would need to find a local organization that is responsible for administering the OPD program in that province.

**Step 2**      **Court Application.** The administrator will make a court application on behalf of the debtor and establish a fixed interest rate of 5%. They will also initiate a stay of proceedings to stop active collection efforts of creditors.

**Step 3**      **Make Monthly Payments.** The debtor is required to make monthly payments over a term of 26–48 months; payments are set based on the debtors ability to pay.

---

The OPD program will be reflected on the debtor’s credit report for a period of two years. This is because while payments are being made, they are not the originally agreed upon payment terms.

## Advantages and Disadvantages of an OPD

### **What are the advantages of a OPD?**

An OPD minimizes or eliminates interest charges. On average, APR is reduced 0 to 10%. It is common for a debtor to become debt-free with 36 to 60 payments. It allows a debtor to make

one, affordable payment for all of their total debt (Debt.ca, 2021).

### **What are the disadvantages of an OPD?**

A debtor cannot use their current credit cards while they are enrolled in the program. They cannot apply for a new credit card while they are enrolled. Their credit card accounts will be closed once they are paid off. The OPD will be noted in the debtor's credit report for two years from the date they complete the program (Debt.ca, 2021).

**Note:** It is important to note that lenders are not licensed insolvency trustees; they can only inform the client of the options that are available to them. It is best for the lender to refer their clients to an LIT to properly advise them on the best options for their situation.

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## Media Attributions

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- Orderly payment of debts

9.

# CHAPTER 8 – COMMERCIAL CREDIT

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## Learning Objectives

### LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- the four different types of business entities in Canada.
- the intricacies of commercial credit and how it differs from consumer credit.
- the five Cs of commercial credit.
- the importance of financial analysis in commercial credit.

- the different types of ratios used by commercial lenders.

## Types of Business Entities in Canada

A lender has to understand how the business entities that exist within Canada differ. How a business is organized has implications on its opportunities and borrowing needs. The lender may be able to guide and advise their client when they are deciding which form of ownership is best suited for them.

There are four forms of business ownership in Canada:

1. Sole Proprietorship
2. Partnership
3. Corporation
4. Cooperative

*(Note: We will be focusing on the first three forms of business ownership. Cooperatives are often funded internally and rely on other sources outside of a financial institution.)*

It is likely that these business entities have been explained in other courses. In this course, we will approach these business entities from a lender's perspective.

Why do we care about the form of the business entity we are lending to?

- Each form has distinct tax and liability provisions for the owners.
- These provisions result in different credit structures and credit-risk reduction methods.

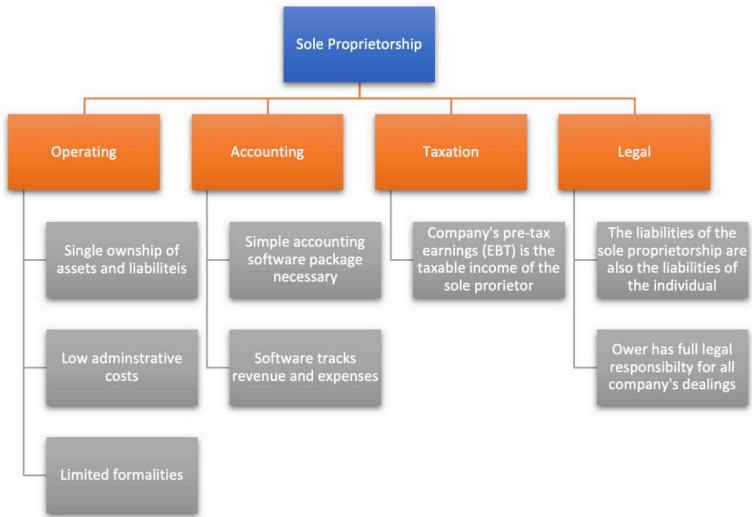
## Sole Proprietorship



Many small businesses start as a sole proprietorship, and there are many reasons for a business to choose this option. The main benefit to registering a business as a sole proprietorship is the cost—it is inexpensive. Sole proprietorship is also flexible; there is less documentation required for setup. The flexibility of the structure also offers a higher degree of control, which allows for faster decisions, making it easier to take advantage of opportunities as they arise. The tax filing process is simplified for a sole proprietor as well.

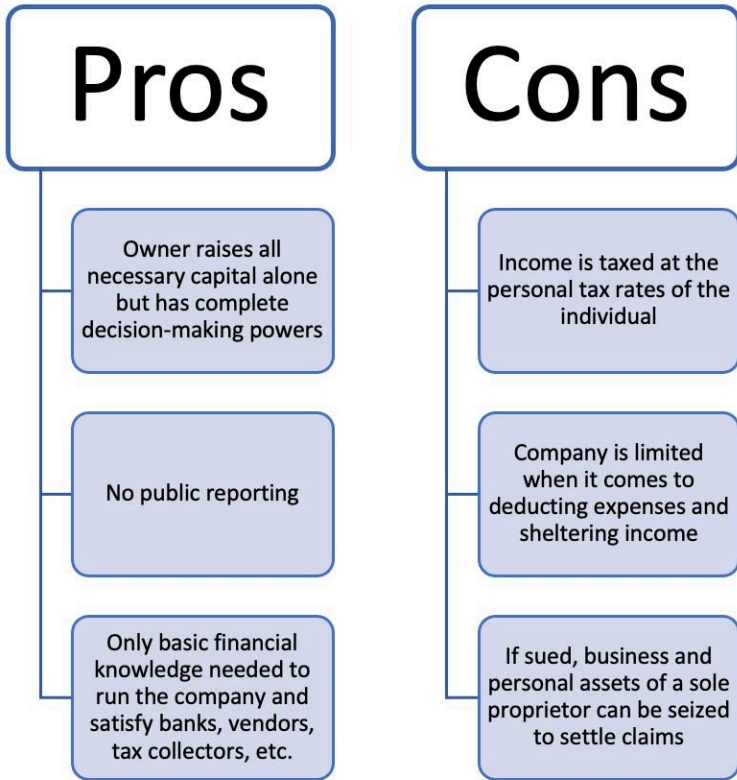
Proprietorship is the simplest way a business can be structured. For a business to become a sole proprietorship, the owner needs to (bdc, 2022):

- register a trade name;
- obtain a tax number; and
- open a bank account.



[Figure 8.2] Features of a sole proprietorship.

[Figure 10.2] Features of a sole proprietorship.



[Figure 8.3] Pros and cons of a sole proprietorship.

According to Farber, a licensed insolvency trustee headquartered in Toronto, 15% of start-ups fail in their first year, and only 50% make it to their fifth year (Farber, 2022). Other concerns that face sole proprietors are the following:

- the owner's personal assets are at risk—a creditor can collect from the owner's personal assets; and
- there is there is typically a lack of management skills.

A way to address the first risk is to ensure that sufficient personal assets exist and that the principal/owner has disability and life insurance (which may require tax returns and personal and business financials).

## Partnership



A partnership is a business that two or more owners establish. Like sole proprietorships, partnerships are relatively simple and inexpensive to form (bdc, 2022). Advantages for the owners are that they can pool their assets and skills to help start their business right. To establish a partnership, the owners need to do the following:

- register a trade name;
- obtain a tax number; and
- open a bank account.

Owners will typically work out a partnership agreement that outlines the ownership shares, capital contributions, and the percentage of ownership and decision-making powers each will have. In this written agreement, the following would be accounted for:

**[Table 8.1] Elements accounted for in the written partnership agreement. (Source: Professor Carla Van Horne, NAIT)**

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the amount of investment from each partner

the division of management responsibilities

the limitations and conditions for withdrawal of cash

the division of loss and/or profit

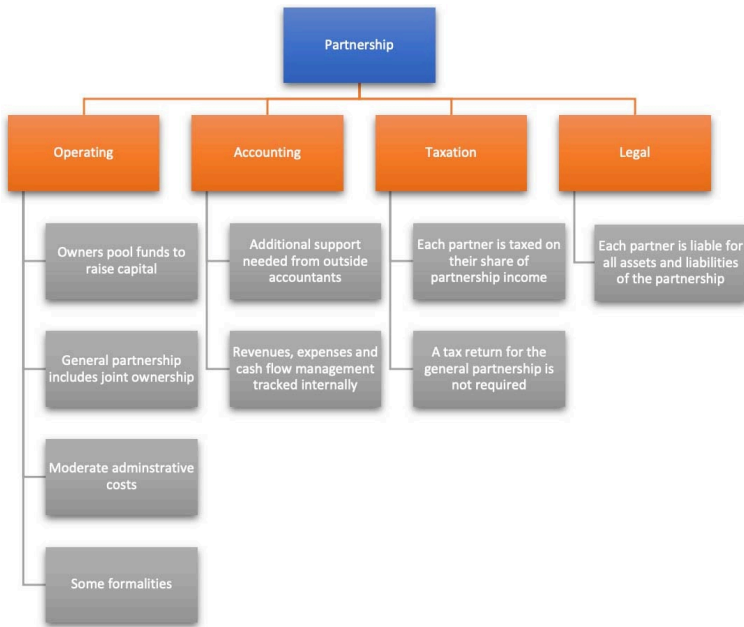
the provisions regarding admission and withdrawal of partnerships

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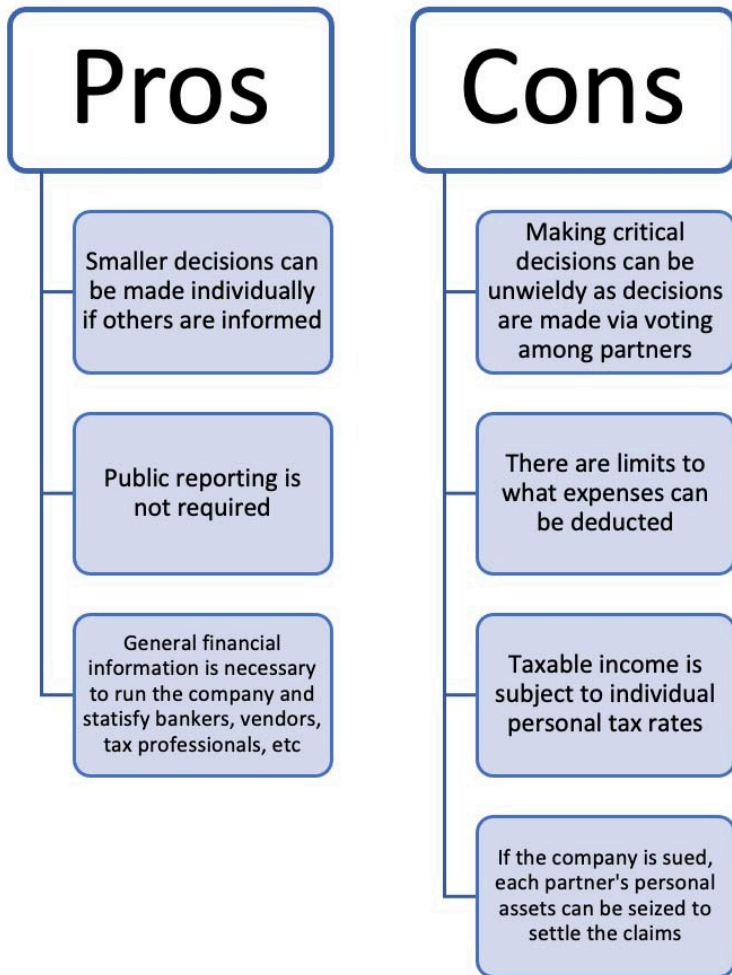
Lenders will need a copy of this agreement so they can determine how it will impact their lending decisions and risk mitigation.

Some negative aspects of a partnership include the following:

- creditors can collect from partners’ assets;
- partners are jointly and severally liable for debts;
- it is the most likely business entity to dissolve;
- there is an immediate dissolution if one partner dies;
- and
- partners may pass the buck to each other on decision-making.



[Figure 8.5] Features of a partnership.



[Figure 8.6] Pros and cons of a partnership.

According to the Local Government Chronicle, 70% of partnerships fail to deliver their intended outcomes. The key drivers of this high rate of failure are a lack of trust and deteriorating relationships (LGC Contributor, 2008). A

lender may advise their clients to consider incorporation as their clients' business grows.

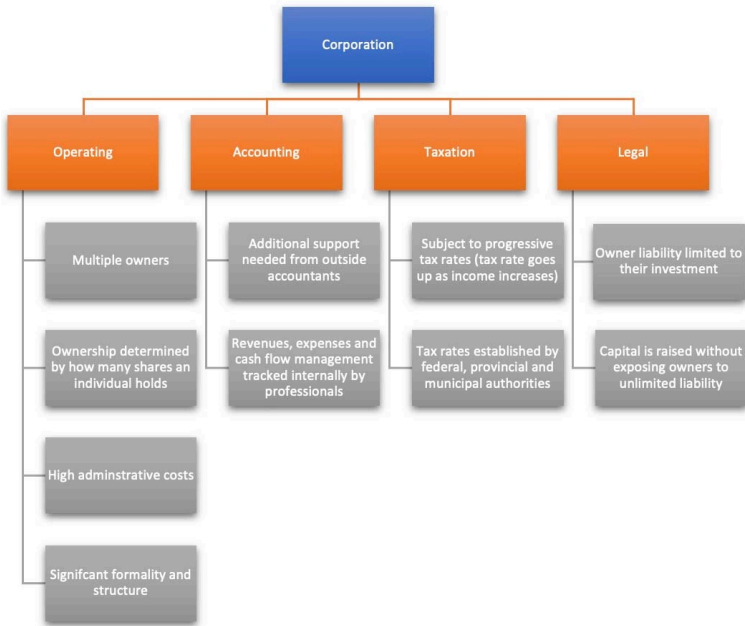
## Corporation.



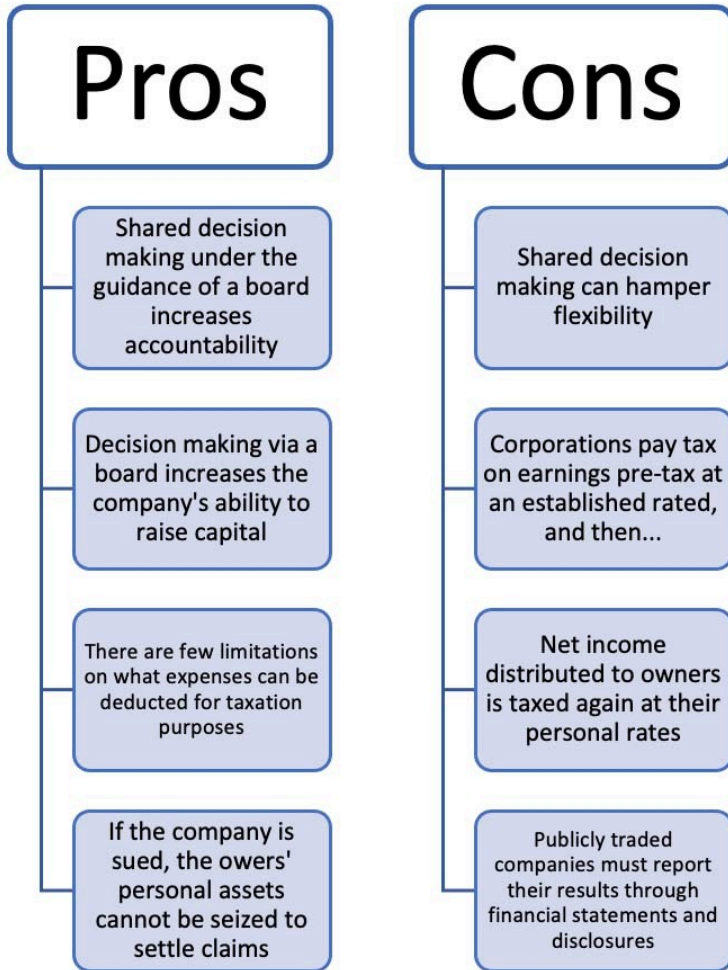
A corporation is a separate legal entity. It has the ability to enter into contracts in its name and be distinctly separated from its owners. Corporations can raise large amounts of capital more easily than a sole proprietor or partnership (Government of Canada, 2022). The process for setting up a corporation is expensive and complex. Entrepreneurs should work with an accountant and a corporate lawyer when establishing their corporation. In Canada, a corporation is created when one or more entrepreneurs register a business

provincially or federally through the filing of the articles of incorporation. The articles of incorporation describe the business and its purposes and list the officers, directors, and the bylaws (bdc, 2022).

Corporations have unlimited lives and can, in theory, exist forever. When the owner dies, the company can continue on without issue. Owners' personal assets are not at risk like they are in a sole proprietorship or partnership, and creditors can only seek payment from the assets of the corporation (bdc, 2022).



[Figure 8.8] Features of a corporation.



[Figure 8.9] Pros and cons of a corporation.

The main benefit of forming a corporation is the protection it provides from creditors; however, the costs to establish a corporation are often a hindrance to new, start-up business.

Lenders need to be prepared to advise their clients on the best options and refer them to a corporate lawyer as needed.

## Types of Business Activities

Why do you need to know what a client's business does? The lender needs to identify if there are possible restrictions on lending, applicable to certain types of businesses, due to the nature of the entity (government) or its level of risk (casino or amusement park). Plus, understanding what a business does may influence the loan structure.

Types of businesses include the following:

- manufacturing;
- wholesaling;
- retailing;
- service; and
- other (e.g., agriculture, mining, construction).

The type of business the client is involved in will impact the type of loan required, the level of risk, and the repayment schedule of the loan.

## Commercial Credit: Financing for a Business

Commercial credit (or lending) is when a bank/financial institution lends funds to a business to help that business with its capital funding needs. In most cases, collateral is required (e.g., property or equipment) for commercial lending. Collateral helps to mitigate risk in the event a bank cannot collect if the business declares bankruptcy. Future cash flows from future accounts receivable can be taken as collateral if needed.

Commercial credit is contingent on the company's viability. Banks want to see progression in a company's long-term plans and feel confident that their debt will be repaid. Commercial lending often involves more parties and more signing authorities, and all have a say in the business and the taking on of debt. When a significant number of people are involved in the decision-making process for a business, there is often less personal contact between lender and client. The lender will need to determine the best contact method (the one also preferred by the client) so timely communication can occur. The entire process (from start to finish) of a commercial credit file can be lengthy. A lender needs to collect the information needed without having to go back to the client multiple times. Given that the lender will likely have less contact with the

client, waiting for information can impede the entire loan process.

The structure of the debt in commercial lending could be lending a lump sum repaid in scheduled installments, and the debt is usually self-liquidating. Depending on the needs of the business, the term of the loan(s) could be short or long. Short-term funding needs could be for operational costs or to purchase equipment to facilitate business operations.



[Figure 8.10] A general framework for commercial lending includes the steps described. (Source: Professor Carla Van Horne, NAIT)

**Step 1: Screen against loan policy.** The lender needs to determine whether the request for capital is within the scope of the financial institution’s lending parameters. If the request is suitable and meets the parameters of the financial institution, the lender can continue.

**Step 2: Gather data (e.g., financials, business plan,**

**forecasts).** The lender requests access to financial statements from the client; at a minimum, three years of statements are required. It is preferred that these statements are audited. Depending on the request, the lender may also ask for a business plan. A business plan helps the lender and financial institution determine how serious the business is about the request they are making. Financial forecasts are often requested. The financial institution is looking to see how this request for capital could potentially be realized and when the debt can be repaid.

**Step 3: Analyze financial data.** This involves a financial ratio analysis, which will be covered later in this chapter.

**Step 4: Complete financial risk, management risk, and market risk assessments.** These assessments are a continuation of the previous step but will often go further. They involve the lender interviewing key people within the organization.

**Step 5: Build projections or analyze projections.** The lender reviews the projections provided to check for accuracy. There are situations where the lender will be required to build projections.

**Step 6: Identify risk mitigation strategies.** The lender seeks out any risk concerns and determines the risk can be mitigated by collateral.

**Step 7: Determine pricing.** This varies from financial institution to financial institution. Usually, the lender and financial institution will consider the strength of the client, the assets being pledged as collateral, and the purpose of the request when they are determining pricing for the debt.

## Types of Commercial Loans

Commercial loans are often considered to be a short-term source of funding for business needs. Some financial institutions will offer renewable loans that may end up being extended indefinitely (Kenton, 2020). During the renewable period, the business is required to produce the needed documentation to ascertain their ability to continue carrying the debt load. Examples of these types of capital requests include the following:

- purchase of assets which will result in sales, then cash (i.e., machinery and equipment, a manufacturing plant, another company [assets are always taken as security]); and
- finance receivables (or inventory) to even out/bridge cash flow (accounts receivables or inventory is security).

The key is to identify the *real* reason the business needs the loan. The real reason is not always the reason given by the client. For example, a client requests a “working capital” loan

to meet payroll. The lender investigates and finds that the problem is not a temporary cash shortage but is actually slow collections. The lender will need to find out why this is occurring and determine if it is on-going or temporary.

## Questions to Ask

- Is there any policy restricting the stated loan purpose?
- Is the loan purpose to finance an illegal activity?
- What is the real loan purpose?
- How long is the trading cycle? Changed?
- What is the financing gap? ( $ACP + DSI - APP$ )

## What should a lender investigate?



Nature of the loan



Repayment period and the manner of repayment



Collateral for the loan



Economic/industry conditions that might impact the borrower's creditworthiness



Project's viability (knowing the industry and how its performance relates to the economic and business cycle)



Management's integrity and competence



Management's intention to repay the loan in the agreed upon manner



Business/businessperson's past record  
Are they successful?

[Figure 8.11] What a lender looks at when reviewing a credit proposal. (Source: MBA Knowledge Base, 2022)

Should the borrower address these issues, the chances are that the loan would indeed be paid in record time.

## The Five Cs Analysis

### THE 5 Cs OF CREDIT



#### **CHARACTER**

Borrower's reputation for repaying debt



#### **CAPACITY**

Borrower's ability to pay debt when due



#### **CAPITAL**

Financial strength of borrower to repay debt



#### **COLLATERAL**

Pledge of an asset to mitigate risk or provide an incentive to borrower



#### **CONDITIONS**

External conditions that could impact a business

The five Cs of credit assist the lender in determining a client's creditworthiness

. This goal is to determine the likelihood of default based on the information available at the time of application. The five Cs is one of the tools the lender can use to determine the risk and balance against the needs of the client and the financial institution. The list of Cs for commercial credit is different from what is seen with consumer credit in Chapter 3. The lender needs to distinguish between the different types of clients when lending.

## Character

Character forms the foundation of a management risk assessment. Here, the lender seeks to establish the borrower's reputation for repaying debts. Does the borrower demonstrate a willingness to honour its obligations? Look at their repayment history and credit record. Some questions the lender should ask to establish character are:

- Does the company have ethical business practices?
- Is the company willing to provide information?
- What is the company's profit retention history?
- Does the company have a dividend policy?
- Does company have justifiable compensation for management/owners?

- Are there signs of trouble? This can include misleading advertising/pricing, frequent change of suppliers, fires, and labour problems.

Remember, the character of a small, privately held company may come from the character of the principals.

## Capacity

Capacity is part of both the management risk assessment and the financial risk assessment. The lender seeks to determine the borrower's financial ability to pay their debts when due. A review would be required in which the lender reviews the business's financials to determine its profitability and long-term viability. This includes doing a historical review and reviewing forecast statements that the business provides. Some questions the lender should ask are to establish capacity are the following:

- What is the capacity of the business to repay any new debt?
- What is the capacity of the business itself to get paid?
- What is the capacity of the business to receive and absorb payments?
- What is the capacity of the financial institution to expose themselves to extending credit to this business?

The lender will also need to consider the intangibles of the business. This includes things such as the experience and training the business owners have in their business/industry. How long have they been in business? This dive into the business will include looking at their knowledge and experience with financials, marketing, production, and purchasing. Moreover, the staff and the location of the business is critical. Are they able to maintain staffing levels or are there concerns surrounding staff turnover? Is the business located in an area that lends to itself to a successful business? Or is the business in an area cut off from shipping routes? Capacity also seeks to see how the business has handled challenges in the past. Are they innovative and willing to take on new technology?

## Capital

Capital looks at a business's long-term financial strength to repay their debt. Does the business owner(s) invest in their own business? The lender looks at the balance sheet to see the current position and makeup of the business's debt structure. How are they currently managing to pay their debts? The lender reviews the business's level of working capital, net worth, and cash flow. This helps the lender ascertain the financial viability of the business's debt structure. Does the business have the ability to take on more debt? Furthermore,

where does this new capital request fit in with the overall debt structure?

Audited financials are preferred and often required by financial institutions, and, if needed, the lender may contact the accountant who prepared the financials. The challenge of reviewing financials is that the lender is trying to determine a business's future ability to pay. Combining all the Cs of credit is critical to help determine whether approval is warranted.

## Collateral

In some cases, collateral helps mitigate risk in a credit deal, or it can provide an incentive for the borrower to repay their debt. In business lending, some collateral is required. Having collateral will help mitigate risk and help establish the business's future ability to pay. Typically, in commercial lending, the pledge of an asset (e.g., real estate or equipment) is necessary to satisfy the collateral requirement. Appraisals may be required to determine the value of an asset being pledged for collateral.

## Conditions

Conditions refer to the external conditions that could impacted the business the lender is analyzing. Are there any systemic or environmental issues that the business faces or

could face? For example, when considering a logging business, an environmental impact could be the recent increase in forest fires. How is the business structured to handle such situations? Lenders also need to consider the economic impacts that a business can experience. How does the business's management overcome these situations? Government actions are another consideration. If the government mandates specific legislation, what are the implications to the business? Conditions explore how well a company can cope with change and how change could impede their ability to pay their bills.

## Financial Analysis



Financial analysis helps evaluate the performance of a business and potentially identify problems (bdc, 2022). Analysis provides the lender with more information so they can make a better credit decision and establish the degree of risk associated with granting credit to a customer. Financial analysis also helps answer the five Cs of credit.

## Financial Statements



When obtaining a business's financial statements, the lender should request three years of statements. The lender should receive the following:

- the balance sheet;

- the statement of earnings (income statement);
- the statement of retained earnings; and
- the statement of cash flows.

The lender can request/obtain the financial statements from the customer, from a trade reporting agency, and, if company is publicly traded, statements are readily available on their website. Banks can demand financial statements, but trade creditors cannot. An analysis of a business's financial statements is only one facet of credit analysis and may raise more questions than provide answers.

Some key takeaways to remember about financial statements are the following:

- Financial statements do not predict the future.
- Three years of statements are necessary to determine trends.
- Statements should be audited for fraud.
- It can be tough to obtain financial statements.
- Statements should be centered around generally accepted accounting principles (GAAP) (Kenton, 2022).

## Types of Financial Statement Analysis

Financial statement analysis is the process of analyzing a company's financial statements for decision-making purposes

(Kenton, 2022). There are different types of analysis, including the following:

- **Simple analysis.** This involves the analysis of one set of statements.
- **Comparative analysis.** This involves the analysis of two sets of statements or one set and industry ratios.
- **Trend analysis.** This involves the analysis of three or more sets of statements.
- **Comparative trend analysis.** This involves the analysis of trends for a customer compared to the trends for the industry.

Lenders use certain standards to ascertain what the results of the analysis indicate. They use ratios from one or more previous periods, industry standards, and rule of thumb to come to a conclusion about the results they observed.

# Ratio Analysis



## Classification of Ratios Used by Lenders

### Liquidity

Liquidity ratios provide the lender with information on how quickly a business is able to pay its debts (Hayes, 2021). These ratios are a good indicator of how well a company can cover their expenses. They help lenders determine how quickly a business can generate cash to purchase assets and repay their creditors.

## **Profitability**

Profitability ratios essentially seek to determine whether a business can make profit. A business then uses these profits to repay their debts—again a focus for a lender.

## **Solvency**

Solvency ratios are used to determine how well a business is managing their debt obligations. Lenders view these ratios to determine how a business is using long-term debt to support the business.

## **Activity Ratios**

Activity ratios can indicate the efficiency of a business and how clients are leveraging their assets on the balance sheet to generate sales and cash.

## Liquidity Ratios

Can a business meet its current obligations? (This indicates the availability of ready cash.)

***Current Ratio = Current Assets/Current Liabilities***

- 2:1 preferred
- if low, a company may not be able to pay its debts
- if high, inefficient use of resources

- business should always have more current assets than current liabilities

***Quick Ratio = Current Assets – Inventory/Current Liabilities***

- also known as the ACID TEST ratio
- 1:1 is preferred
- if low, a company may not be able to pay debts
- if high, inefficient use of resources
- identifies any risk of potential cash flow problems

***Working Capital = Current Assets – Current Liabilities***

- Working capital is used to measure a business's ability to generate cash to pay for its short-term financial obligations.
- Positive working capital indicates that a business has the ability to meet their monthly obligations.
- Negative working capital is a concern; the business will likely have difficulty meeting their monthly obligations.

## Profitability Ratios

Is the company profitable?

***Net Profit Margin = Net Income/Net Sales \* 100 (expressed as a percentage)***

- If low, the business may not be profitable after paying its operating expenses.
- If high, this is better unless prices for the product or service are too high and reduce sales.

***Return on Investments (or ROA) = Net Income/Total Assets (expressed as a percentage)***

- varies by industry
- If low, may be due to poor performance; check income statements items.
- the higher, the better

***Return on Equity (or Return on Shareholders Equity) = Net Income/Equity (expressed as a percentage)***

- Ratio should be greater than prevailing interest rates.
- If low, may be due to poor performance; check income statement items.
- the higher, the better

## Activity Ratios

How is the company being run?

***Accounts Receivable Days Sales Outstanding = Account Receivable \* 365 Days/Sales***

***\*also known as Average Collection Period (ACP)***

- Should be slightly higher than the terms of sale; not exceeding 1.5 times.
- if low, strong control of receivables
- if high, poor control of receivables or deliberate acceptance of higher risk accounts

***Inventory Turnover = Cost of Good Sold/Inventory***

- Inventory turnover rates vary greatly by industry.
- if low, poor control, possible obsolete stock or over buying
- if high, maintaining insufficient stock; could have poor buying procedures or have been cut off by suppliers; if there is significant variance to industry averages, this indicates too much or not enough investment in inventory.

## Solvency Ratios

What is the contribution of the owners? What is the company's reliance on short- and long-term debt?

***Average Days Payable Ratio = Accounts Payable \* 365 Days/Cost of Sales (or COGS)***

- Total should be close to the industry's average terms; not

exceeding 1.5 times.

- If low, the enterprise may be on COD terms with suppliers or paying early (discounts).
- If high, the enterprise is paying beyond term; there is a danger that suppliers will refuse to offer credit if this is excessive.

***Debt to Asset Ratio = Total Liabilities/(Current Assets + Fixed Assets)*** (expressed as a percentage)

- indicates the percentage of a business's assets financed by creditors
- low ratio is a good indicator that a company is able to pay its debts or take on new opportunities
- high ratio indicates dependence on debt and could indicate financial weakness

***Debt to Equity Ratio = Total Liabilities/Shareholders Equity***

- Measures the amount of debt a business is carrying compared to the amount invested by its owners.
- If low, it is a strong company; easy to borrow/lend.
- If high, it is highly leveraged and risky; may have high interest rate expense; difficult to borrow/lend.

Five Cs of Commercial Credit	Ratios
<b>Character:</b> repayment history	Average Days Payable Period Ratio
<b>Capacity:</b> financial ability to pay debts when due	Current Ratio
Profitability and long-term viability: historical and forecast statements	Acid Test
Intangibles: experience and training in business and industry; financial, marketing, production, purchasing knowledge and experience; staff; location	Net Profit Margin
	Inventory Turnover
	ACP
<b>Capital:</b> can they repay?	Working Capital
Shows LT financial strength to pay	Debt to Asset
Equity, shareholders loans, retained earnings, working capital, sufficient working capital	Debt to Equity
Debt ratios	ROI
	RDE
<b>Condition</b>	Look at trends
<b>Collateral</b>	N/A

[Table 10.5] Aligning the ratios with the five Cs analysis. (Source: Professor Carla Van Heme, HAIT)

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## 10.

# CHAPTER 9 –TRADE CREDIT

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### Learning Objectives

## LEARNING GOALS

**Upon completion of this chapter, you should understand:**

- the definition of trade credit and its specific characteristics.
- the role of the credit manager.
- what a credit policy is and what's typically included.
- what's included in a credit application.
- how the five Cs of analysis apply to trade

credit.

- the advantages and disadvantages of trade credit.

## Trade Credit



Trade credit is a business-to-business agreement where one can purchase supplies and goods as needed without paying cash up front. Usually, a business agrees to repayment terms of 30, 60, or 90 days, which is documented on an invoice (Kagan, 2021). Trade credit allows for a business to receive a revenue stream and then collect funds to cover the cost of goods sold. Trade credit is a form of

credit with no interest and is considered unsecured. It is important that lenders handling trade-credit accounts seek to maximize sales at an acceptable level of risk (minimize the bad debts), maintain accounts receivable turnover (collect cash), and control expenses overall.

## Characteristics of Trade Credit

- Trade credit analysis seeks to determine risk and weigh it against the overall needs of the seller.
- There are few customers; 75% of sales are generated by 25% of customers.
- It is more personal; there is one on one contact with customers.
- One or two large customers can have a big impact on a seller.
- It is unsecured.
- It is very short term.
- It is self-liquidating.

## Credit Managers and Their Role in Trade Credit



In these types of businesses, the role of the credit manager is to oversee the function of trade credit, and, in a sense, accounts receivable. The responsibilities of the credit manager are to evaluate new and recurring applicants and assess them for creditworthiness, while also balancing the business credit risk for all the business's customer accounts. Credit managers are often responsible for initiating collections when a customer fails to pay (Sidor, 2016).

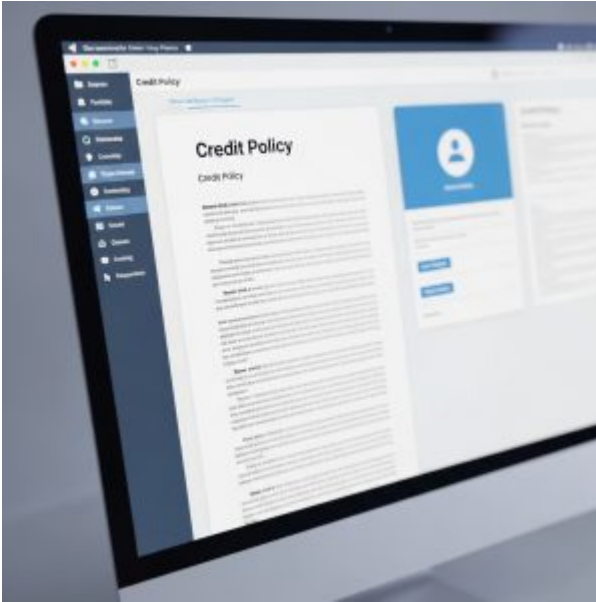
## Trade Credit Analysis

When granting credit, a credit manager has to make determinations between customers who will pay and customers who will not pay (CFI Team, 2020). This is a challenging position for the credit manager to be in, given that the debt is unsecured. The credit manager has to make the best decision possible at the time. The credit manager needs to have good communication with the sales team to ensure they are up to date on which customers are paying and which aren't. A credit manager can look at a number of different sources of information to assist them in making informed decisions and reducing risk.

[Table 9

- 
- A credit manager can request **financial statements** from a customer and the
  - A credit manager can review a customer's **credit reports**. Credit reports include information about a firm's credit strength.
  - A simple way to determine a customer's creditworthiness is to review the cus
  - A credit manager will commonly review the **five Cs of credit** (character, cap
-

# Credit Policy



A business should have established a credit policy. Developing and enforcing a credit policy are risk management tools that protect a business from customers that can't meet payment deadlines on time (or ever.) Credit policies will outline the credit department's governing principles for how trade credit is handled. As the credit policy has a direct impact on sales, it is also considered a marketing tool for the business.

Typically, a credit policy should include the following (adapted from Dun & Bradstreet, 2022):

1. **What is the mission of the credit policy?** The

mission statement of a credit policy should align with the company's mission statement. An example from Dun & Bradstreet, *“The credit department defines the requirements for establishing trade credit for new customers and maintaining credit lines and limits for active accounts and returning customers with appropriate payment terms. The credit department also strives to offer optional payment methods to facilitate sales to customers with sub-optimal credit histories.”*

2. **What are the goals of the policy?** This may be common sense, but one key goal should be that the company will collect on the extended credit. Another goal could be that the company will keep the percentage of past due accounts below a certain target. Overall, these goals should be in alignment with the overall business goals.
3. **Who has specific credit responsibilities?** Roles and responsibilities should be clearly defined. Having authority and responsibilities clearly stated will create efficiencies and reduce redundancies. For example, a policy could dictate that credit managers are solely responsible for assessments and approvals. This will help to minimize collections and will also align with corporate financial goals (e.g., a “pre-check” from sales will not expedite the order).
4. **How is credit evaluated?** This is where a business can establish the level of risk they are willing to take on. A

policy that accepts higher risks to achieve higher sales can see larger bad debts occurring and increased costs due to financing receivables. A policy which is risk averse to minimize bad debts can see high credit department costs because of more thorough investigations and, ultimately, lower sales.

5. **How are collections handled?** The collections process should be documented and followed for each customer. This will ensure consistency and, ultimately, help the business achieve the goal of collecting funds owed. Consequences for customers who are not meeting the terms of their agreements should be made clear and included in the invoice that is provided to customers.
6. **What are the terms of sale?** Deciding on the terms of sale will depend on the products/services that a business provides. Consider the competitors' terms of sale when establishing the terms of sale; this can have a direct impact on a business's sales.

Click the following link to further review Dun & Bradstreet's [Sample Credit Policy](#).

Once a credit policy has been established, a business should ensure that proper training and documentation of procedures exist to reduce any confusion among employees. Having a process in place allows for periodic review and helps determine how successful the policy is.

## Credit Application



Much like a credit application in a consumer credit situation, trade credit requires the collection of information. This is so the credit manager can be better informed when they are granting or extending credit. The following information is needed in a basic trade credit application.

**Contact Information.** This will include the company's name, names of the business owners, and the address for billing and shipping. This should also include the accounts payables/receivables contact information.

**Bank References.** Bank references are easier to obtain if the

customer uploads their bank's information along with their credit application. If they do not provide this upload, the credit manager will need to get a signed agreement from the customer to send to the bank to release this information. Customers may hesitate to provide this information due to privacy concerns. A business should incorporate proper security for the collection of sensitive information.

**Trade References.** Trade references can be difficult to obtain but do help with determining the customer's repayment history with other businesses. In some instances, the customer can provide their utility or credit card bills. Some businesses may use a credit report.

**Financial Information.** A customer should provide their financials so the creditor manager can do a quick review of the financial viability of the customer's business. Depending on the policies of the business granting the trade credit, unaudited financials may be acceptable.

**Terms and Conditions.** Terms and conditions should include the penalties and late fees that can be applied for non-payment. It is advisable to have a lawyer review this section to ensure the application/agreement can be enforced.

## The Five Cs Analysis and Trade Credit



Similar to consumer (Chapter 3) and commercial credit (Chapter 8), the analysis of the five Cs is required with trade credit. This analysis helps the credit manager determine if they will grant or extend credit.

- **Character.** During a credit application interview, a credit manager will be looking at a customer's repayment history and their willingness to provide information. For on-site interviews, a credit manager (or sales representative) should make observations about the

management and staff, review comments from other suppliers, and ask for the names of suppliers an applicant didn't mention.

- **Capacity.** Capacity looks at a customer's ability to meet credit obligations out of operating cash flows. Specifically, it addresses working capital, margins, and business knowledge. For on-site interviews, a credit manager (or sales representative) would observe customer traffic, inventory levels, clientele, and comments from other suppliers.
- **Capital.** This looks at a customer's financial reserves (i.e., long-term financing and equity). In an on-site interview, a credit manager (or sales representative) would make note of the condition of premises, levels of inventory, and equipment.
- **Collateral.** Collateral, as discussed previously, is a pledged asset in case of default. In trade credit, a credit manager can ask for collateral by securing a note or by asking for a corporate or personal guarantee (Dun & Bradstreet, 2022). A business can also carry trade credit insurance to mitigate losses from bad debts.
- **Conditions.** The credit manager will look at general economic conditions and review any industry conditions or problems.

It is important to note that trade credit and a company's credit policy is only as good as their collection policy. Click the

following link to review Dun & Bradstreet's [Strategies for a More Effective Collections Policy](#).

# Advantages and Disadvantages

## Advantages and Disadvantages

### ADVANTAGES

**Increased Sales:**  
Extending credit to customers allows for sales to increase, as customers would otherwise not be able to purchase from suppliers.

**Competitive Advantage:**  
Not all businesses are able to extend trade credit; this presents an opportunity for those that can.

**Incentives for Customers to Pay:**  
Trade credit encourages customers to pay early by offering discounts for early payments.

### DISADVANTAGES

**Negative Effect on Cash Flow:**  
Cash is not immediately realized for the sales while extending trade credit.

**Must Investigate Creditworthiness of Customers:**  
The credit application process takes time.

**Financing Accounts Receivable:**  
The business may need to finance their accounts receivable while waiting on repayment.

**Possibility of Bad Debts:**  
Extending trade credit

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